

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-55050; File No. SR-BSE-2006-03)

January 5, 2007

Self-Regulatory Organizations; Boston Stock Exchange, Inc.; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto, Relating to the Treatment of Limit Orders that Are Submitted to the Boston Options Exchange During a Price Improvement Period

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on December 8, 2006, the Boston Stock Exchange, Inc. (“BSE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change. On January 4, 2007, the BSE filed Amendment No. 1 to the proposed rule change. The proposed rule change is described in Items I, II, and III below, which Items have been prepared substantially by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

As described in more detail herein, the Exchange proposes to modify the Boston Options Exchange (“BOX”) Rules to clarify the treatment of Limit Orders that are submitted to the BOX during a Price Improvement Period (“PIP”).³ In addition, this proposal clarifies that certain Improvement Orders (as explained below) are not accepted by the BOX Trading Host. The text of the proposed rule change is available at the Exchange, the Commission’s Public Reference Room, and http://www.bostonstock.com/legal/pending_rule_filings.html.

¹ 5 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Capitalized terms not otherwise defined herein shall have the meanings prescribed under the BOX Rules.

II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The self-regulatory organization has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The purpose of the proposed rule change is to clarify the treatment of Limit Orders that are submitted to the BOX during a PIP. In addition, this proposal clarifies that certain Improvement Orders (as explained below) are not accepted by the BOX Trading Host.

I. Background and Introduction

In general, the BOX PIP is a three-second auction starting at a price better than the current National Best Bid and Offer (“NBBO”), during which BOX Participants compete to participate in the execution of the Customer Order submitted to the PIP (the “PIP Order”) by submitting specially designated orders called Improvement Orders in one penny increments that are only accepted in a PIP auction. A Limit Order, in the same series as the PIP Order, that is submitted to BOX during a PIP auction is considered an “unrelated order” pursuant to the BOX PIP Rules,⁴ and under certain circumstances, may prematurely terminate the PIP or may immediately execute against the PIP Order. When the PIP is prematurely terminated, the PIP Order is matched against the best prevailing orders on BOX (whether Improvement Orders or

⁴ See paragraph (a) of Section 18 of Chapter V of the BOX Rules.

unrelated orders received by BOX during the PIP).⁵ Then the Limit Order is filtered from trading through the NBBO and executed accordingly.⁶

Competing Principles Underlying the Treatment of Unrelated Orders in a PIP

The BOX trading system operates under four main principles when handling the interaction of an unrelated Limit Order with the PIP process. Specifically, the BOX system:

1. Allows the PIP to continue for as long as possible. The BSE believes that in most cases this will maximize the price improvement potential to the PIP Order.
2. Maintains the relative price/time priority of all orders on the system, including Improvement Orders.
3. Will not allow Improvement Orders to lock or cross the BOX Book.
4. Never “holds-up” the processing of any order and seeks to execute an order as quickly as practicable in order to mitigate the risk of adverse market movements.

On the few occasions when these four principles intersect or are in conflict, BSE has sought to maintain a reasonable balance between the interests of all orders while offering each order the best available price, without violating any BOX Rules or the securities laws. Therefore, the first principle, allowing the PIP to continue for as long as possible, will apply until it conflicts with any of the other three (3) principles.

Consideration of the size of orders or the potential execution volume at any PIP price level is not one of these main principles of the BOX system. The BOX system does not consider

⁵ Pursuant to Paragraph (e)(iii) of Section 18 of Chapter V of the BOX Rules.

⁶ Pursuant to Paragraph (b) of Section 16 of Chapter V of the BOX Rules (“Filter Rule”). Pursuant to the Filter Rule, a Limit Order that has a Buy (Sell) limit price equal to or better than the National Best Offer (Bid), and the Best BOX Offer (Bid) is not equal to the National Best Offer (Bid), the Limit Order is “exposed” for three seconds to seek potential BOX orders that can match the National Best Offer (Bid) before the order is routed to an away market that is equal to the National Best Offer (Bid).

the number of contracts that may be executed at the best PIP improvement price when determining priority or when the PIP should terminate. Having at least one contract available at the best improvement price is all that is required.

II. Same Side Limit Orders-Premature Termination Events

The submission to BOX of a Limit Order that is on the same side of the market as the PIP Order will prematurely terminate the PIP, allowing the PIP Order to be immediately executed against the best prevailing orders on BOX (whether Improvement Orders or unrelated orders received by BOX during the PIP), if at the time the Limit Order is submitted to BOX:

- i. the Buy (Sell) Limit Order price is equal to or higher (lower) than the National Best Offer (Bid) and either:
 - (a) the BOX Best Offer (Bid) is equal to the National Best Offer (Bid); or
 - (b) the BOX Best Offer (Bid) is higher (lower) than the National Best Offer (Bid) and the price of the best Improvement Order is equal to or lower (higher) than the National Best Offer (Bid); or
- ii. the Buy (Sell) Limit Order price is lower (higher) than the National Best Offer (Bid) and its limit price equals or crosses the price of the best Improvement Order.⁷

In short, a same side Limit Order will terminate the PIP if the Limit Order matches the best BOX price (i.e., the BOX BBO or the best Improvement Order) provided the best BOX price is better than or equal to the NBBO (i.e., the Limit Order is marketable)⁸ or if the Limit Order is non-marketable and its limit price is superior to the best Improvement Order.

⁷ See proposed paragraph (i) of Section 18 of Chapter V of the BOX Rules.

⁸ A Limit Order is marketable when the Buy (Sell) Limit Order price is equal to or higher (lower) than the National Best Offer (Bid).

Therefore, the first factor to consider when determining whether the PIP will prematurely terminate is whether the Limit Order is marketable upon receipt by BOX.

A. If the Limit Order is Marketable

The rule contemplates two different marketable Limit Order scenarios.

1. Scenario One

At the time of the submission of the Limit Order, the Buy (Sell) Limit Order price is equal to or higher (lower) than the National Best Offer (Bid) and the BOX Best Offer (Bid) is equal to the National Best Offer (Bid).⁹ The following example illustrates this scenario.

Example A-

TABLE A

NBBO	BOX BBO	PIP Order	Best IO Price	Limit Order Price	Limit Order Size	Early Termination	PIP Order Execution
2.00-2.10	2.00-2.10	Buy 20k	2.07	Buy at 2.10	20	YES	2.07

As shown in Table A, assume the NBBO and the BOX BBO in the relevant series are \$2.00 bid - \$2.10 offer and the PIP Order is a buy order for 20 contracts. The PIP starts at \$2.09 (one penny better than the National Best Offer). During the PIP auction, Improvement Orders are submitted to the PIP until the price of the best Improvement Order is \$2.07 for 20 contracts. Then a Limit Order to buy 20 contracts at a limit price of \$2.10 is submitted to BOX. In this example, since the Buy Limit Order price of \$2.10 is equal to the National Best Offer also at \$2.10 and the BOX Best Offer of \$2.10 is equal to the National Best Offer at \$2.10, then the PIP will immediately terminate. Upon termination, the PIP Order will execute in full against the best Improvement Order at \$2.07 and any remaining Improvement Orders will be immediately

⁹ See proposed paragraph (i)(i)(a) of Section 18 of Chapter V of the BOX Rules.

cancelled. The Buy Limit Order will then execute against the BOX Offer at \$2.10. The result would be the same regardless of the Limit Order size or if the best Improvement Order was anywhere between \$2.09 through \$2.01.¹⁰

BSE wants to maximize the price to the PIP Order while also minimizing any potential market risk to the Limit Order by having BOX execute the Limit Order as soon as a matching order is available at the National Best Offer (Bid). In order to avoid a delay of the Limit Order execution against the matching BOX Offer, which Offer might otherwise be cancelled, BSE has chosen to strike a balance among the competing principles and give the PIP Order the price improvement that is immediately available to the PIP Order by prematurely terminating the PIP auction. In this Example A, if a PIP is not underway the Limit Order could execute against the BOX Offer at \$2.10. However, in this situation in which a PIP is underway, allowing the PIP to continue and immediately executing the Limit Order at \$2.10 against the BOX Offer would violate BOX price priority rules. This is because the best Improvement Order at \$2.07 is at a lower (i.e., better) price than the limit price of \$2.10. On BOX, even though Improvement Orders may only execute against PIP Orders, price priority rules still apply, and no order can be executed at a price inferior to the best price available to another order.

2. Scenario Two

At the time of the submission of the Limit Order, the Buy (Sell) Limit Order price is equal to or higher (lower) than the National Best Offer (Bid), the BOX Best Offer (Bid) is higher (lower) than the National Best Offer (Bid), and the price of the best Improvement Order is equal

¹⁰ The Trading Host will not accept Improvement Orders equal to or lower than \$2.00 because the BOX system will not allow Improvement Orders to lock or cross the Best Bid or Offer on the BOX Book. See proposed Supplementary Material .03 to Section 18 of Chapter V of the BOX Rules and discussion below.

to or lower (higher) than the National Best Offer (Bid).¹¹ The following is an example of this market scenario.

Example B-

TABLE B

NBBO	BOX BBO	PIP Order	Best IO Price	Limit Order Price	Limit Order Size	Early Termination	PIP Order Execution
2.00-2.05	2.00-2.10	Buy 20k	2.05	Buy at 2.05	20	YES	2.05

If we take Example A above and make the following changes in the market scenario: the NBBO improves to \$2.00 bid - \$2.05 offer after the PIP begins, the best Improvement Order is for 20 contracts at \$2.05, and a Limit Order with a limit price to buy at \$2.05 is submitted to BOX, the PIP would also terminate prematurely. In this Example B, since the Buy Limit Order price of \$2.05 is still equal to the National Best Offer also at \$2.05 (i.e., marketable), the BOX Best Offer (\$2.10) is higher than the National Best Offer (\$2.05) and the price of the best Improvement Order (\$2.05) is equal to the National Best Offer at \$2.05, the market conditions meet the requirements of the rule and the PIP will immediately terminate. The PIP Order will execute in full against the best Improvement Order at \$2.05 and any remaining Improvement Orders will be immediately cancelled. Because the Limit Order matches the National Best Offer at \$2.05 the Limit Order would be exposed internally on BOX at \$2.05 pursuant to the Filter Rule.¹²

As in Scenario One, BSE wants to maximize the price to the PIP Order while also limiting the market risk to the Limit Order, by having BOX give the Limit Order the opportunity

¹¹ See proposed paragraph (i)(i)(b) of Section 18 of Chapter V of the BOX Rules.

¹² Section 16(b) of Chapter V of the BOX Rules.

to execute as soon as practicable at the National Best Offer (Bid). In this case, because the BOX Offer at \$2.10 is inferior to the National Best Offer at \$2.05, the Limit Order would ordinarily (i.e., absent a PIP auction underway) be exposed at \$2.05 pursuant to the Filter Rule. However, if the BOX trading system were to continue the PIP, no further price improvement would be possible when the best Improvement Order is \$2.05. The Trading Host could not accept Improvement Orders equal to or lower than the \$2.05 Limit Order price as long as the Limit Order is being exposed because the Limit Order would have priority and the BOX system will not allow Improvement Orders to lock or cross the opposite side BOX Best Bid of \$2.05.¹³

Alternatively, if BOX were to hold the unrelated Limit Order until the end of the PIP auction this could cause the Limit Order to lose an opportunity to trade. Rather, BSE has chosen to strike a balance among the competing principles by giving the PIP Order the then-available price improvement and prematurely terminating the PIP.

If the best Improvement Order was only at \$2.07 in Example B, the best Improvement Order price would be higher than the National Best Offer price of \$2.05, and the PIP would continue because it does not create a situation that violates BOX price/time priority rules. The Limit Order would be exposed internally on BOX at \$2.05. Although the PIP continues, the Trading Host would not accept Improvement Orders equal to or lower than the \$2.05 Limit Order price because it will not allow Improvement Orders to lock or cross the opposite side order exposed on the BOX Book.¹⁴

¹³ See proposed Supplementary Material .03 to Section 18 of Chapter V of the BOX Rules and discussion below.

¹⁴ See proposed Supplementary Material .03 to Section 18 of Chapter V of the BOX Rules and discussion below.

B. If the Limit Order is Non-Marketable

The PIP auction will also prematurely terminate early when at the time of the submission, the Buy (Sell) Limit Order price is lower (higher) than the National Best Offer (Bid) (i.e., non-marketable) and the price of the Limit Order equals or crosses the price of the best Improvement Order.¹⁵ The following is an example of this market scenario.

Example C-

TABLE C

NBBO	BOX BBO	PIP Order	Best IO Price	Limit Order Price	Limit Order Size	Early Termination	PIP Order Execution
2.00-2.10	2.00-2.10	Buy 20k	2.05	Buy at 2.05	20	YES	2.05

As shown in Table C, assume the NBBO and the BOX BBO are \$2.00 bid - \$2.10 offer and the PIP Order is a buy order for 20 contracts. The PIP starts at \$2.09 (one penny better than the National Best Offer). During the PIP auction, Improvement Orders are submitted to the PIP until the price of the best Improvement Order is \$2.05 for 20 contracts. Then a Limit Order to buy 20 contracts at a limit price of \$2.05 is submitted to BOX. In this Example C, since the Buy Limit Order price of \$2.05 is lower than the National Best Offer at \$2.10 and the limit price equals or crosses the price of the best Improvement Order (i.e., \$2.05), then the PIP will immediately terminate. The PIP Order will execute in full against the best Improvement Order at \$2.05 and any remaining Improvement Orders will be immediately cancelled. The Buy Limit Order will then be placed on the BOX Book at \$2.05.

As in the other scenarios, BSE wants to maximize the price to the PIP Order and also limit the market risk to the Limit Order, by having BOX display the Limit Order and giving the

¹⁵ See proposed paragraph (i)(ii) of Section 18 of Chapter V of the BOX Rules.

Limit Order the opportunity to execute as soon as practicable. In this case, because the Buy Limit Order at \$2.05 is better than the current BOX Best Bid at \$2.00, the Limit Order must be displayed at \$2.05 pursuant to the Display Rule.¹⁶ However, if the BOX trading system were to continue the PIP, it could create a situation very similar to the one explained in Scenario 2 and Example B above. Specifically, no further price improvement would be possible when the best Improvement Order is \$2.05. The Trading Host could not accept Improvement Orders equal to or lower than the \$2.05 Limit Order price as long as the Limit Order is being displayed because the Limit Order would have priority and the BOX system will not allow Improvement Orders to lock or cross the opposite side BOX Best Bid of \$2.05.¹⁷

For clarification purposes only, the following is a similar scenario in which the PIP would not prematurely terminate.

Example D-

TABLE D

NBBO	BOX BBO	PIP Order	Best IO Price	Limit Order Price	Limit Order Size	Early Termination	PIP Order Execution
2.00-2.10	2.00-2.10	Buy 20k	2.07	Buy at 2.05	20	NO	2.07 or 2.06

Assume we take Example C above and make the following changes in the market scenario: Improvement Orders are submitted to the PIP until the price of the best Improvement Order is \$2.07 for 20 contracts. Upon receipt of the Buy Limit Order, there wouldn't be an order on BOX that the Limit Order could execute against and the Limit Order would then be placed on the BOX Book at \$2.05 and displayed as the BOX Best Bid. Because the Improvement Order at

¹⁶ Section 16(a) of Chapter V of the BOX Rules.

¹⁷ See proposed Supplementary Material .03 to Section 18 of Chapter V of the BOX Rules and discussion below.

\$2.07 is higher than the \$2.05 Limit Order price, the PIP will continue. BOX will not accept Improvement Orders lower than \$2.06¹⁸ because this would lock or cross the BOX Best Bid (the Limit Order at \$2.05).

III. Opposite Side Limit Order-Immediate Execution

The submission to BOX of a Limit Order on the opposite side of a PIP Order will immediately execute against a PIP Order when the Sell (Buy) Limit Order price is equal to or crosses the National Best Bid (Offer) and;

- i. the BOX Best Bid (Offer) is equal to the National Best Bid (Offer); or
- ii. the BOX Best Bid (Offer) is lower (higher) than the National Best Bid (Offer) and neither the best Improvement Order nor BOX Best Offer (Bid) is equal to or crosses the National Best Bid (Offer).

In short, the opposite side Limit Order will immediately execute against a PIP Order when the Limit Order could match the BOX Best Bid (Offer) and/or the National Best Bid (Offer) and the Limit Order is superior to the best Improvement Order. Whether the opposite side Limit Order is marketable¹⁹ or not upon receipt by BOX is the first factor to consider when determining whether the Limit Order will immediately execute against the PIP Order. If the Limit Order is marketable and the best Improvement Order is not equal to or lower (higher) than the National Best Bid (Offer), then the Limit Order immediately executes against the PIP Order up to the lesser of (a) the size of the PIP Order, or (b) the size of the Limit Order.²⁰ The

¹⁸ The BOX Trading Host is programmed to continue to accept Improvement Orders at \$2.06 or higher and will not accept Improvement Orders at \$2.05 or lower unless the Limit Order is cancelled, in which case the Trading Host will begin to accept them again.

¹⁹ For an opposite side Limit Order, it is marketable when the Sell (Buy) Limit Order price is equal to or lower than the National Best Bid (Offer).

²⁰ The remainder of the Limit Order, if any, is filtered from trading through the NBBO pursuant to the Filter Rule and executed accordingly. The remainder of the PIP Order, if

execution price of the PIP Order against the Limit Order in this case will be determined by whether the BOX Best Bid (Offer) is equal to the National Best Bid (Offer) or it is lower (higher) than the National Best Bid (Offer) at the time of execution. Where the Limit Order is for at least the full size of the PIP Order, the PIP is prematurely terminated with the cancellation of all the Improvement Orders.

A. If the BOX BBO Equals the NBBO

If the BOX Best Bid (Offer) is equal to the National Best Bid (Offer) at the time of the execution, then the execution price will be one penny better than the National Best Bid (Offer).

Example E

TABLE E

NBBO	BOX BBO	PIP Order	Best IO Price	Limit Order Price	Limit Order Size	Execute Against PIP Order	PIP Order Execution
2.00-2.10	2.00-2.10	Buy 20k	2.07	Sell at 2.00	20	YES	2.01

As shown in Table E, assume the NBBO and the BOX BBO in the relevant series is \$2.00 bid - \$2.10 offer and the PIP Order is a buy order for 20 contracts. The PIP starts at \$2.09 (one penny better than the National Best Offer). During the PIP interval, Improvement Orders are submitted to the PIP until the price of the best Improvement Order is \$2.07. Then, assume a Limit Order to sell 20 contracts with a limit price of \$2.00 is submitted to BOX. Because the Sell Limit Order price is equal to the National Best Bid at \$2.00 (i.e., marketable) and the BOX Best Bid of \$2.00 is equal to the National Best Bid, the Limit Order will be immediately executed in full against the PIP Order at \$2.01, one penny better than the National Best Bid.

any, continues in the PIP process.

Since the Limit Order is the same size as the PIP Order, the PIP terminates as well in this example. Any Improvement Orders will be immediately cancelled.

BSE wants to maximize the price to the PIP Order and also limit the market risk to the Limit Order, by having BOX give the Limit Order the opportunity to execute as soon as a matching order is available. In this case the PIP Order is immediately available to execute against the Limit Order at \$2.01, which provides price improvement to both the PIP Order and the Limit Order. “Holding” the Limit Order until the PIP has run its full course might cause the Limit Order to miss the \$2.00 BOX Best Bid which could be cancelled or modified during the lapse. Also, the PIP Order could have missed the opportunity to receive an execution at \$2.01. In contrast, allowing the PIP to continue without immediately executing the Limit Order against the PIP Order would cause a violation of BOX priority rules. First, in this example, executing the Limit Order against the PIP Order at the National Best Bid of \$2.00 would violate the time priority of the \$2.00 order on the BOX Book that is the BOX Best Bid price. Additionally, if the Limit Order did not immediately execute against the PIP Order, the Limit Order would have been executed at \$2.00 with the BOX Best Bid, which would be a priority violation of the PIP Order, which can trade at \$2.01. In order to not violate priority rules and also to not hold up the Limit Order from executing against a matching order, BSE has chosen to strike a balance among the competing principles and give the PIP Order as well as the Limit Order the price improvement that is immediately available.

In contrast, the PIP would continue if the Limit Order in Example E had a limit price of \$2.05 instead of \$2.00, making it non-marketable, in which case the Limit Order would be placed on the BOX Book and displayed. Meanwhile, BOX gives the PIP Order the opportunity for further improvement. Since the Limit Order price of \$2.05 is better than the best

Improvement Order at \$2.07, the Limit Order might be available to execute against the PIP Order at the end of the PIP process.²¹

Example F

TABLE F

NBBO	BOX BBO	PIP Order	Best IO Price	Limit Order Price	Limit Order Size	Execute Against PIP Order	PIP Order Execution
2.00-2.10	2.00-2.10	Buy 20k	2.07	Sell at 2.00	30	YES	2.01

If we take Example E above and make the following changes in the market scenario: a Limit Order to sell 30 contracts with a limit price of \$2.00 is submitted to BOX, the Limit Order would be partially executed against the PIP Order at \$2.01 and the remainder of the Limit Order (10 contracts) would be filtered from trading through the NBBO pursuant to the Filter Rule and execute with the size of BOX Bid at \$2.00. However, if in this Example F the Limit Order was a Limit Order to sell 10 contracts, the Limit Order would be executed in full against the PIP Order at \$2.01, and the remainder of the PIP Order would continue in the PIP process.

B. The BOX BBO Does Not Equal the NBBO

When the BOX Best Bid (Offer) is lower (higher) than the National Best Bid (Offer) and neither the best Improvement Order nor BOX Best Offer (Bid) is equal to or crosses the National Best Bid (Offer), the PIP Order will execute against the Limit Order and the execution price will be the National Best Bid (Offer).

²¹ The Limit Order could be cancelled before the end of the PIP, in which case the Limit Order would not be available to execute with the PIP Order.

Example G

TABLE G

NBBO	BOX BBO	PIP Order	Best IO Price	Limit Order Price	Limit Order Size	Execute Against PIP Order	PIP Order Execution
2.05-2.10	2.00-2.10	Buy 20k	2.07	Sell at 2.00	15	YES	2.05

As shown in Table G, assume the NBBO in the relevant series is \$2.05 bid and \$2.10 offer and the BBO is at \$2.00 bid -\$2.10 offer, the PIP Order is a buy order for 20 contracts, and the best Improvement Order is \$2.07. Then an opposite side unrelated Limit Order to sell 15 contracts at \$2.00 is received. Because the Sell Limit Order price is lower than or equal to the National Best Bid at \$2.05 (i.e., marketable), the BOX Best Bid of \$2.00 is lower than the National Best Bid at \$2.05, and the best Improvement Order at \$2.07 does not equal or cross the National Best Bid at \$2.05, the Sell Limit Order will be immediately executed in full against the PIP Order at the National Best Bid of \$2.05. The PIP will proceed to duration for 5 contracts, which may or may not receive additional Improvement Orders lower than the \$2.07 price (perhaps to the best possible price for the PIP Order of \$2.01).

BSE wants to maximize the price to the PIP Order while limiting the market risk to the Limit Order, by having BOX give the Limit Order the opportunity to execute as soon as a matching order is available. In this case it is the PIP Order that is immediately available at the price of \$2.05, which provides price improvement to both the PIP Order and the Limit Order. This situation occurs because the BOX Best Bid of \$2.00 is lower than the National Best Bid of \$2.05, so pursuant to the Filter Rule, the BOX system will seek to have the Limit Order executed at the National Best Bid price of \$2.05. Since this price is lower than the BOX Best Offer (\$2.10), and also lower than the best Improvement Order (\$2.07), the Limit Order is also the best price available for the PIP Order.

Therefore, in order to maximize the price improvement to the PIP Order the unrelated opposite side Limit Order will immediately execute against the PIP Order ensuring the PIP Order a \$2.05 price for 15 contracts.

The benefit of this policy can also be shown by contrasting it with the possible outcomes if BOX allowed the PIP to continue without immediately executing the Limit Order against the PIP Order. In this situation, if the Limit Order does not execute against the PIP Order, then the Limit Order would be exposed on the BOX Book at \$2.05 to seek a buy order at \$2.05. However, the Limit Order could be cancelled prior to the receipt of a response, in which case the PIP Order would end up trading with the Improvement Order at an inferior price (\$2.07) to the Limit Order price (\$2.05). Alternatively, allowing the Limit Order to be exposed on the BOX Book at \$2.05 could result in the submission of a responsive buy order, which would stop the PIP at that point because the buy order is a same side unrelated order. Therefore, it is more reasonable to avoid this unnecessary, and potentially detrimental, delay and instead follow Example G by immediately executing the PIP Order and the Limit Order at \$2.05 upon receipt of the Limit Order.

C. Addition Example- Opposite Side Limit Order

In order to further clarify the operation of the rule for opposite side Limit Orders, consider the following example where the Limit Order does not immediately execute against the PIP Order.

Example H

TABLE H

NBBO	BOX BBO	PIP Order	Best IO Price	Limit Order Price	Limit Order Size	Execute Against PIP Order	PIP Order Execution
2.05-2.10	2.00-2.10	Buy 20k	2.05	Sell at 2.00	15	NO	2.05

Take Example G above and make the following changes in the market scenario: the price of the best Improvement Order is \$2.05. The Limit Order will not immediately execute against the PIP Order at \$2.05 because the PIP Order is already likely to receive at least a partial execution at \$2.05 with the best Improvement Order.²² Therefore, the PIP continues in order to seek further price improvement with the unrelated Limit Order being exposed as a sell at \$2.05 in accordance with the Filter Rule.

IV. Matching Unrelated Orders

In order to further clarify the operation of the rule for unrelated Limit Orders as discussed above, consider the following example where the first unrelated Limit Order does not terminate the PIP and a second unrelated order that could match the first is received by BOX.

Example I

TABLE I

NBBO	BOX BBO	PIP Order	Best IO Price	IO Size	#1 Limit Order Price	#1 Limit Order Size	#2 Limit Order Price	#2 Limit Order Size	PIP Order Execution
2.05-2.10	2.00-2.10	Buy 20k	2.05	5	Sell at 2.00	20	Buy at 2.05	20	2.05

Take Example H above and make the following changes in the market scenario: the size of the best Improvement Order at \$2.05 is only 5 contracts; a “same side” unrelated order is also received (Limit Order #2). As in Example H, the “opposite side” Limit Order #1 will not immediately execute against the PIP Order at \$2.05 because the PIP Order is already likely to receive at least a partial execution at \$2.05 with the best Improvement Order (in this case 5

²² This occurs even if the aggregate quantity of the best Improvement Orders at \$2.05 or lower do not equal the full size of the PIP Order (i.e., the system does not check to determine that the combined quantity of all the Improvement Orders at \$2.05 or lower is for the full size quantity of the PIP Order). See Example I.

contracts). Therefore, the PIP continues in order to seek further price improvement with the unrelated Limit Order #1 being exposed as a sell at \$2.05 in accordance with the Filter Rule.

However, if a buy order for \$2.05 is received in response to the exposure of the sell Limit Order #1, this Limit Order #2 would also be considered an unrelated same side Limit Order. As in Example C, since the buy Limit Order price of \$2.05 is lower than the National Best Offer at \$2.10 and the limit price equals the price of the best Improvement Order (\$2.05), then the PIP will immediately terminate. As stated above, when the PIP is prematurely terminated, the PIP Order is matched against the best prevailing orders on BOX (whether Improvement Orders or unrelated orders received by BOX during the PIP).²³ Therefore, in this Example I the PIP Order will execute in full - 5 contracts against the best Improvement Order at \$2.05 and the remaining 15 contracts against the exposed opposite side unrelated Limit Order #1 at \$2.05 because the Limit Order was next in time priority. Since the two unrelated orders match, the remaining size of Limit Order #1 will then execute 5 contracts against Limit Order #2 at \$2.05. The remaining 15 contracts of Limit Order #2 will then be placed on the BOX Book and displayed at \$2.05.

Additional Matching Unrelated Order Examples

Example J

TABLE J

NBBO	BOX BBO	PIP Order	Best IO Price	Limit Order Price	Limit Order Size	Execute Against Second Limit Order	PIP Order Execution
2.00-2.10	2.00-2.10	Buy 20k	2.07	Sell at 2.05	20	NO	2.05

As shown in Table J, assume the NBBO and the BOX BBO in the relevant series is \$2.00 bid - \$2.10 offer and the PIP Order is a buy order for 20 contracts. The PIP starts at \$2.09 (one

²³ Pursuant to Paragraph (e)(iii) of Section 18 of Chapter V of the BOX Rules.

penny better than the National Best Offer). During the PIP interval, Improvement Orders are submitted to the PIP until the price of the best Improvement Order is \$2.07. Then, assume a Limit Order to sell 20 contracts (i.e., opposite side of the market from the PIP Order) with a limit price of \$2.05 is submitted to BOX. The PIP would continue because the Sell Limit Order price is higher than the National Best Bid, making it non-marketable, in which case the Limit Order would be placed on the BOX Book and displayed as the new BOX Best Offer (and new National Best Offer) at \$2.05. Meanwhile, BOX gives the PIP Order the opportunity for further improvement. Since the Limit Order price of \$2.05 is better than the best Improvement Order at \$2.07, the Limit Order might be available to execute against the PIP Order at the end of the PIP process. Then a Limit Order to buy 20 contracts (i.e. on the same side of the market as the PIP Order), with a limit price of \$2.05 is submitted to BOX. Since the buy Limit Order price of \$2.05 is equal to the new National Best Offer, then the PIP immediately terminates. The Sell Limit Order would be executed with the PIP Order in full at \$2.05. The Buy Limit Order would be placed on the BOX Book and displayed as the BOX Best Bid at \$2.05.

Example K

TABLE K

NBBO	BOX BBO	PIP Order	Best IO Price	Limit Order Price	Limit Order Size	Execute Against Second Limit Order	PIP Order Execution
2.00-2.10	2.00-2.10	Buy 20k	2.04	Sell at 2.05	20	YES	2.05

As shown in Table K, assume the NBBO and the BOX BBO in the relevant series is \$2.00 bid - \$2.10 offer and the PIP Order is a buy order for 20 contracts. The PIP starts at \$2.09 (one penny better than the National Best Offer). The only difference from Example J is that during the PIP interval Improvement Orders are submitted to the PIP until the price of the best Improvement

Order is \$2.04. Then, assume a Limit Order to sell 20 contracts (i.e., opposite side of the market from the PIP Order) with a limit price of \$2.05 is submitted to BOX. The PIP would continue because the Sell Limit Order price is higher than the National Best Bid, making it non-marketable, in which case the Limit Order would be placed on the BOX Book and displayed as the new BOX Best Offer (and new National Best Offer) at \$2.05. Meanwhile, BOX gives the PIP Order the opportunity for further improvement. Since the Limit Order price of \$2.05 is worse than the best Improvement Order at \$2.04, the Limit Order would not execute against the PIP Order at the end of the PIP process. Then a Limit Order to buy 20 contracts (i.e. on the same side of the market as the PIP Order), with a limit price of \$2.05 is submitted to BOX. Since the buy Limit Order price of \$2.05 is equal to the new National Best Offer, then the PIP immediately terminates. The best Improvement Order would be executed with the PIP Order in full at \$2.04. The Sell Limit Order would then execute with the Buy Limit Order in full at \$2.05.

V. Improvement Order Clarification

The BOX Trading Host does not accept Improvement Orders that lock or cross the BOX Book on the same side of the market as the PIP Order. To accept such Improvement Orders would violate the price priority of the resting orders on the BOX Book.

VI. Reports

BSE is currently obligated to provide certain reports to the Commission that provide data about BOX-Top and Market Orders that terminate the PIP prematurely, as well as BOX-Top and Market Orders that immediately execute against a PIP Order. BSE represents that it will provide the same information for Limit Orders that terminate the PIP prematurely or immediately execute against a PIP Order.

2. Statutory Basis

The Exchange believes that the proposal is consistent with the requirements of Section 6(b) of the Act,²⁴ in general, and Section 6(b)(5) of the Act,²⁵ in particular, in that it is designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts, 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 by clarifying the treatment of Limit Orders that are submitted to the BOX during a PIP and that certain Improvement Orders are not accepted by the BOX Trading Host.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

The Exchange has neither solicited nor received comments on the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding, or (ii) as to which the Exchange consents, the Commission will:

- (A) by order approve such proposed rule change, or
- (B) institute proceedings to determine whether the proposed rule change should be

disapproved.

²⁴ 15 U.S.C. 78f(b).

²⁵ 15 U.S.C. 78f(b)(5).

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change 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-2006-03 on the subject line.

Paper Comments:

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

All submissions should refer to File Number SR-BSE-2006-03. 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. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. 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-2006-03 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁶

Florence E. Harmon
Deputy Secretary

²⁶ 17 CFR 200.30-3(a)(12).