

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-55230; File No. SR-BSE-2006-16)

February 2, 2007

Self-Regulatory Organizations; Boston Stock Exchange, Inc.; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto to Adopt a Universal Price Improvement Period for Public Customer Orders

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on December 11, 2006, the Boston Stock Exchange, Inc. (“BSE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been substantially prepared by the BSE. On February 1, 2007, BSE filed Amendment No. 1 to the proposed rule change.<sup>3</sup> 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

The Exchange proposes to amend the rules of the Boston Options Exchange (“BOX”) to adopt a Universal Price Improvement Period (“UPIP”) to offer the opportunity for price improvement for eligible Public Customer<sup>4</sup> orders. The text of the proposed rule change is available at BSE, the Commission’s Public Reference Room, and

[http://www.bostonstock.com/legal/pending\\_rule\\_filings.html](http://www.bostonstock.com/legal/pending_rule_filings.html).

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> In Amendment No. 1, BSE granted the Commission an extension of the time period specified in Section 19(b)(2) of the Act for Commission action.

<sup>4</sup> 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 BSE 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 BSE 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

Currently, the BOX offers Options Participants, who wish to price improve their Customer Orders, access to a price improvement auction referred to as the "PIP" (Price Improvement Period). In order for a Customer Order to be entered into a PIP auction, Options Participants must be willing to improve the execution price themselves or seek price improvement through the PIP via a Directed Order. In either instance, initial access to the PIP is dependent upon the ability of at least one party to guarantee price improvement for the full size of the Customer Order. UPIP, however, is a universal price improvement mechanism such that all Public Customer Orders submitted to the BOX Trading Host will be eligible for potential price improvement in the UPIP auction, subject to the eligibility requirements discussed below. UPIP is similar to the PIP and other price improvement mechanisms, such as the Price Improvement Mechanism ("PIM") of the International Stock Exchange, Inc. ("ISE") and the Simple Auction Liaison system ("SAL") of the Chicago Board Options Exchange, Incorporated ("CBOE"), that initiate auctions in penny increments through which exchange participants compete to potentially price improve a customer order above the National Best Bid or Offer

(“NBBO”). Unlike the PIP and other similar price improvement mechanisms, however, UPIP permits a broader universe of orders to obtain price improvement.

In the discussion to follow, BSE provides an overview of the UPIP auction and discusses some of the more salient features and benefits of the UPIP. In addition, BSE addresses the underlying purpose of the UPIP by, in part, comparing the UPIP to the industry practice of “paying for order flow,” and by discussing the overall effectiveness of UPIP in the context of the Commission’s Penny Pilot.<sup>5</sup>

a. UIPI Eligibility

Under the proposed rule, a Public Customer Order will be eligible for the UPIP auction (“Eligible Order”) provided certain conditions have been satisfied.<sup>6</sup> For example, the Eligible Order must be a Limit, Market or BOX-Top Order that is marketable against the NBBO.<sup>7</sup> In addition, the Trading Host will not permit the commencement of a UPIP auction in the following scenarios: (1) if a PIP or UPIP in the same series is already underway, or (2) if the NBBO is locked or crossed and the BOX Best Bid or Offer (“BBO”) on the same side of the market as the Eligible Order equals the NBBO.

b. The UPIP Order<sup>8</sup> and the Auction

Upon satisfaction of the foregoing conditions, the BOX Trading Host will proceed to automatically commence a UPIP auction. Prior to the commencement, however, the BOX

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<sup>5</sup> See Securities Exchange Act Release No. 54789 (November 20, 2006), 71 FR 68654 (November 27, 2006) (SR-BSE-2006-49).

<sup>6</sup> See proposed rule Section 29(e) of Chapter V of the BOX Rules.

<sup>7</sup> The Exchange also notes that an Eligible Order must be for a series of options that is open for trading and can not indicate a minimum quantity condition or be an Inbound Inter-Market Linkage P/A order.

<sup>8</sup> Under the proposal, upon commencement of the UPIP auction the “Eligible Order” shall be referred to as the “UIPI Order.”

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 Order (i.e., the UPIP Order’s series, size and side of the market), the end time of the auction, and the applicable Start Price.<sup>9</sup> The Start Price for each auction is driven primarily by the price of the BBO on the opposite side of the market from the UPIP Order vis-à-vis the NBBO such that if the BBO is equal to the NBBO, the Start Price will be one improvement increment (e.g., a penny) better than the NBBO. Conversely, 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.

The rule proposal allows UPIP Orders to 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 all related Improvement Orders. Certain modifications of a UPIP Order will not result in the termination of the UPIP auction. Such modifications include 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. Otherwise, any other modification will result in the termination of the UPIP auction.

c. Improvement Orders and the Auction

Any Options Participant may submit an Improvement Order<sup>10</sup> in response to a Broadcast Message for an impending UPIP auction. Such Improvement Orders shall be visible to all Options Participants and are required to be submitted in increments of one-penny or more and

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<sup>9</sup> The Start Price is defined as the minimum/maximum (buy/sell) price at which an Improvement Order must be submitted.

<sup>10</sup> 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.

must equal or improve the Start Price. Improvement Orders may also 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 modifications of the Improvement Order's limit price will result in the creation of a new Improvement Order reflecting the revised terms (i.e., increased quantity amount or modified price) 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.

d. Improvement Orders and Priority

Like the PIP, Improvement Orders may be submitted by any BOX market participant such as Customers (including CPOs), Order Flow Providers ("OFP"), or Market Makers (including Executing Participants<sup>11</sup>). Improvement Orders will generally be ranked in order of price and time. The rule proposal, however, provides alternative ranking and/or allocation status for certain Improvement Orders depending on certain criteria, as discussed more fully below.

i. Proprietary Improvement Orders

Under the rule proposal, the Options Participant who submitted the Eligible Order to BOX and subsequently submitted a Proprietary Improvement Order will be last in time priority at all price levels in the relevant UPIP auction. Notwithstanding, 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 Participant's Proprietary Improvement Order will be treated like an ordinary Improvement Order and qualify for execution at each price level without prejudice.

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<sup>11</sup> An "Executing Participant" is defined in the BOX Rules as a Market Maker that systemically indicates its willingness to accept and receive Directed Orders. See Section 5(c)(i) of Chapter VI of the BOX Rules.

ii. Executing Participant Improvement Orders

The rule proposal also seeks to deter Executing Participants who receive Directed Orders from simply releasing the Directed Order to the BOX Book in order to compete in the ensuing UPIP auction by placing the Executing Participant last in priority at all price levels in any subsequent UPIP auction related to that Directed Order.

iii. Customer Price Improvement Orders

Similar to the CPO in the PIP, Public Customers that submit a CPO to an OFP must indicate the price at which the order shall be placed in the BOX Book (“BOX Book Reference Price”)<sup>12</sup> 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. In order for the CPO to be eligible for participation in a UPIP auction, the BOX Book Reference Price must equal the BBO at the commencement of a UPIP auction.<sup>13</sup> The CPO will also benefit from enhanced time priority pursuant to NBBO Prime as described in section iv below.

iv. NBBO Prime

The current rule proposal allows certain Improvement Orders to be designated as NBBO Prime (“NBBO Prime Order”). 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 upon satisfaction of certain conditions, as discussed more fully below. Any Improvement Order may be eligible for the NBBO Prime designation in a UPIP auction.

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<sup>12</sup> The BOX Book reference price must be stated in standard five-cent or ten-cent increments.

<sup>13</sup> The Exchange also notes that a CPO must be in the same series and on opposite side of the UPIP Order.

In order to receive the benefits of the NBBO Prime designation, the same beneficial account,<sup>14</sup> such as a customer account, for whom the Options Participant is acting as principal or agent (whether Market Maker, OFFP, or Customer) and is seeking the NBBO Prime designation must itself 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 receipt of the Eligible Order by the Trading Host. In addition, NBBO Prime Orders shall only have enhanced time priority for the quantity that does not exceed the size of its NBBO Prime Participant Quote; any residual quantity will be handled in accordance with the normal time priority rules. As between NBBO Prime Orders, the priority shall be governed by the relevant Trading Host order receipt time stamp of each NBBO Prime Participant Quote.

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, under the proposed rule the Options Participant is permitted the flexibility to 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.

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<sup>14</sup> For purposes of the proposed rule, a “beneficial account” means the underlying type of account (e.g., customer, broker-dealer, market maker, etc.) on whose behalf the Participant is trading.

e. Price Protection in the UPIP

As previously discussed, the potential execution price of any UPIP auction will be, except in limited circumstances,<sup>15</sup> at least equal to the NBBO at the time UPIP auction commences. At the conclusion of the UPIP auction, including in the event of a premature termination (as discussed more fully below), the UPIP Order shall be matched against the best prevailing orders. These orders include Improvement Order(s), CPOs, Unrelated Orders, and quotes submitted during the UPIP auction that are equal to or better than the Start Price. In addition, the rule proposal provides for the initial quantity of the UPIP Order to be “stopped” against any order 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”)<sup>16</sup> up to the size of the Initial Box Book Quote (“Initial Aggregate Quote Size”). When the UPIP auction terminates, the UPIP Order may be matched against the Initial Aggregate Quote Size of the Initial BOX Book Quote and will not be executed at a price worse than the Initial BOX Book Quote.

A modification or cancellation of the Initial BOX Book Quote during the UPIP auction that decreases 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

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<sup>15</sup> At the conclusion of a UPIP auction, the quantity of the UPIP Order that exceeds the Initial Aggregate Quote Size, if any, will not execute against Improvement Orders at prices inferior to the NBBO except in the following circumstances: (1) in accordance with Chapter XII, Section 3(e) of BOX Rules; or (2) the away options exchange posting the NBBO is conducting a trading rotation in that options class.

<sup>16</sup> 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.

cancellation or modification of its order/quote causes the UPIP auction to terminate, will have its order/quote placed at the end of the quote and order queue at the applicable price level on the BOX Book. At which point, the UPIP Order will be matched according to the UPIP trade allocation rules. 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, however, will be processed immediately by the Trading Host without penalty and the UPIP auction will continue.<sup>17</sup>

f. 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 National Best Bid (or Offer) and the best of either the best UPIP Improvement Order, the UPIP Start Price or the National Best Offer (or Bid).<sup>18</sup> If the Unrelated Order on the opposite 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 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.

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<sup>17</sup> The Exchange also notes that 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 as described in this paragraph (n).

<sup>18</sup> Any rounding required will be to the benefit of the Unrelated Order.

g. UIIP versus Payment for Order Flow

As the Commission has previously indicated, payment for order flow (“PFOF”) programs are made possible by the fixed bid/ask spreads that are presently imposed on the marketplace. The UIIP, however, infiltrates those spreads by allowing Options Participants to bid or offer a UIIP Order in penny increments. The UIIP is, in many ways, the antithesis of PFOF programs because it transfers any “payment” that is paid by an Options Participant for an order to the customer, rather than the customer’s broker. The pennies that were once accrued to the broker are now paid directly to customers in the form of price improvement.

h. UIIP and the Penny Pilot

The impending “Penny Pilot Program” planned for 2007 endeavors, in part, to determine whether price improvement is possible in a “penny-quoting” environment and the cost of such an environment in the face of possible increased quote traffic and the related burdens placed on capacity. BOX believes UIIP is the Penny Pilot but on a much grander scale. UIIP will allow penny pricing for all option classes without any traffic consequences.

2. Statutory Basis

The proposal is consistent with the requirements of Section 6(b) of the Act,<sup>19</sup> in general, and Section 6(b)(5) of the Act,<sup>20</sup> in particular, in that it provides potential price improvement in excess of the NBBO to certain qualifying orders, it is generally designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts and, in general, to protect investors and the public interest.

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<sup>19</sup> 15 U.S.C. 78f(b).

<sup>20</sup> 15 U.S.C. 78f(b)(5).

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 that is 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 BSE consents, the Commission shall: (a) by order approve such proposed rule change, or (b) institute proceedings to determine whether the proposed rule change should be disapproved.

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](mailto:rule-comments@sec.gov). Please include File No. SR-BSE-2006-16 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-2006-16. 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. Copies of such filing also will be available for inspection and copying at the principal office of the 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 the date of publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>21</sup>

Florence E. Harmon  
Deputy Secretary

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<sup>21</sup> 17 CFR 200.30-3(a)(12).