

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-56186; File No. SR-BSE-2006-56)

August 2, 2007

Self-Regulatory Organizations; Boston Stock Exchange, Inc.; Notice of Filing of Amendment No. 2 to the Proposed Rule Change and Order Granting Accelerated Approval of Proposed Rule Change as Modified by Amendments No. 1 and 2 Thereto to Add to the Boston Options Exchange a New Functionality Called an Auto Auction Order

I. Introduction

On December 15, 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 Boston Options Exchange (“BOX”) Rules to add a new functionality referred to as an Auto Auction Order (“AAO”) to make it easier for customers to participate in a price improvement auction (“Improvement Auction”). On February 1, 2007, BSE filed Amendment No. 1 to the proposed rule change. The proposed rule change was published for comment in the Federal Register on February 12, 2007.³ The Commission received one comment letter regarding the proposal.⁴ BSE filed a response to the comment letter on June 8, 2007.⁵ On June 8, 2007, BSE

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 55233 (February 2, 2007), 72 FR 6626 (“Notice”).

⁴ See letter to Nancy M. Morris, Secretary, Commission, from Michael J. Simon, Secretary, International Securities Exchange, LLC (“ISE”), dated March 5, 2007 (“ISE Letter”).

⁵ See letter to Nancy M. Morris, Secretary, Commission, from William Meehan, General Counsel, BSE, dated June 8, 2007 (“BSE Letter”).

filed Amendment No. 2 to the proposed rule change.⁶ This order approves the proposed rule change, as modified by Amendments No. 1 and 2, on an accelerated basis.

II. Description of the Proposal

BSE proposes to amend the BOX Rules to add a new order functionality called an AAO that would automatically participate in any Improvement Auction (e.g., Price Improvement Period (“PIP”) auction)⁷ if it meets certain criteria. An AAO is a Limit Order that is submitted by an Order Flow Provider (“OFP”)⁸ on behalf of a Public Customer⁹ to the BOX Trading Host in one-cent increments in a series whose minimum trading increment is greater than one cent. The penny incremented limit price that is entered by the Public Customer is referred to as the “AAO Maximum Improvement Price.” The AAO Maximum Improvement Price is the maximum (if the order is to buy) or minimum (if the order is to sell) price at which the Public Customer is willing to trade in any Improvement Auction.

The BOX Trading Host will round AAOs to the nearest minimum trading increment (up if the order is to sell and down if the order is to buy) and place it on the BOX Book (“AAO Limit Order”). The AAO Limit Order will be processed as a standard Limit Order as described in Chapter 5, Section 14(c)(i) of the BOX Rules and will be traded in accordance with Chapter 5, Section 16 of the BOX Rules.

⁶ In Amendment No. 2, BSE amended the proposal to reflect that AAOs may be entered only for Public Customer accounts and only in a series for which the standard trading increment is greater than one cent. BSE also made corresponding technical changes to the rule text.

⁷ See Chapter V, Section 18 of the BOX Rules.

⁸ “Order Flow Provider” is defined as an Options Participant representing as agent Customer Orders on BOX and those non-Market Maker Participants conducting proprietary trading. See Chapter I, Section 1(a)(46) of the BOX Rules.

⁹ “Public Customer” is defined a person that is not a broker or dealer in securities. See Chapter I, Section 1(a)(50) of the BOX Rules.

A. Eligibility

An AAO will be eligible to participate in any Improvement Auction that may occur when the AAO is on the opposite side of the market from the order seeking improvement and the AAO Limit Price is equal to the National Best Bid or Offer (“NBBO”). If the AAO is eligible, the BOX trading engine will automatically create a new order (the “AAO Improvement Order”) at the end of the auction phase, but prior to any trade allocations, with the following terms:

- (1) the quantity of the AAO Improvement Order will be the lesser of the remaining quantity on the BOX Book at the AAO Limit Price or the quantity of the order seeking improvement in the auction; and
- (2) the price of the AAO Improvement Order will be equal to the price of the best Improvement Order, Primary Improvement Order, or unrelated order (on the same side of the market as the AAO) submitted to the Improvement Auction.

B. Trade Processing of AAO

During an Improvement Auction, if the number of contracts executed in the Improvement Auction against the AAO Improvement Order is less than the quantity of the AAO Limit Order, then, prior to the processing of any other orders in the same series on the opposite side of the market as the AAO Limit Order, the quantity of the AAO Limit Order will be decremented on the BOX Book by the size of the executed quantity of the AAO Improvement Order. Any residual quantity that remains after part of an AAO has traded (either on the BOX Book or in the Improvement Auction) will continue to be eligible to trade in any subsequent Improvement Auctions. In addition, the residual quantity will maintain its priority on the BOX Book in accordance with Chapter V, Section 16 of the BOX Rules.

Any AAO Improvement Order created by the BOX Trading Host will be assigned the time priority of the related AAO Limit Order. As such, the AAO Improvement Order is granted time priority at its relevant price level in an Improvement Auction. Any modification to the AAO Maximum Improvement Price that causes the rounded AAO Limit Price to change or any increase in the quantity of the AAO will cause a new time priority to be assigned to the AAO Limit Order on the BOX Book. Any changes to the AAO Maximum Improvement Price that do not effect the AAO Limit Price will not cause a change to the time priority of the original order.

Additionally, a new AAO received in a particular series that is on the opposite side of the market from another AAO, which is already on the BOX Book, and is marketable at the AAO Maximum Improvement Price of the other booked AAO (e.g., a buy AAO is on the BOX Book with a Limit Price bid of \$2.00 with an AAO Maximum Improvement Price of \$2.03 and a new sell AAO is received by the BOX Trading Host with an AAO Maximum Improvement Price of \$2.02), will be matched at the mid-point of the two AAO Maximum Improvement Prices, rounded to the nearest penny increment in the favor of the AAO that is already on the BOX Book.¹⁰ The quantity of the resulting trade will be for the lesser quantity of the two AAOs.

III. 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

¹⁰ The Commission notes that a non-AAO incoming order that is marketable at the AAO Limit Price will execute against the AAO at the displayed Limit Price.

- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-BSE-2006-56 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 SR-BSE-2006-56. 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, 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-2006-56 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

IV. Discussion

After careful review of the amended proposal, the ISE Letter, and the BSE Letter, 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 exchange¹¹ and, in particular, the requirements of Section 6 of the Act.¹² Specifically, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,¹³ 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.

A. Order Exposure

The proposal provides that the undisplayed penny price of an AAO resting on the BOX Book can execute against the undisplayed penny price of another AAO.¹⁴ The commenter notes that other orders in the BOX marketplace, such as market orders and limit orders that are marketable against the displayed price of an AAO, would not receive the benefit of the hidden penny price. The commenter believes that the proposal thus provides a mechanism by which participants can cross orders on BOX with no exposure to the marketplace.¹⁵ In response, BSE

¹¹ 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).

¹² 15 U.S.C. 78f.

¹³ 15 U.S.C. 78f(b)(5).

¹⁴ See proposed Chapter V, Section 14(c)(v)(F) of the BOX Rules.

¹⁵ See ISE Letter, supra note 4, at 1-2.

has amended its proposal to limit the use of the AAO to only Public Customers.¹⁶ The Commission believes that the amended proposal is consistent with Section 6(b)(5) of the Act.¹⁷

B. Priority and Price Competition

The commenter also argues that the AAO would not provide for additional price improvement opportunities, would discourage aggressive competition in the PIP, and would unfairly advantage the AAO in the PIP auction. First, the commenter contends that the AAO would not provide for any increased opportunities for price improvement in the PIP because the AAO Improvement Order would be generated at the conclusion of the three second exposure period (and thus not be broadcast to other BOX Participants) and would only match the best price provided by other BOX participants, even if the AAO contained an AAO Maximum Improvement Price that would provide additional price improvement to the PIP order.¹⁸ Second, the commenter believes that the proposal will discourage other BOX Participants from competing aggressively for PIP orders because it provides time priority for the AAO Improvement Order in the PIP based upon the entry time of the original AAO. Third, the commenter argues that the AAO is unfairly advantaged in the PIP auction because only through use of an AAO can a participant adjust the price at which they are willing to participate in the PIP auction without other participants knowing about its interest and still maintain its initial time priority.¹⁹

¹⁶ See Amendment No. 2, supra note 6.

¹⁷ 15 U.S.C. 78f(b)(5).

¹⁸ See ISE Letter, supra note 4, at 2.

¹⁹ See ISE Letter, supra note 4, at 3. As noted above, an AAO would not lose its initial time priority if there are changes to the initial penny order price, so long as the change does not affect the displayed limit order price. See proposed Chapter V, Section 14(c)(v)(E) of the BOX Rules.

In response, BSE argues that the AAO will provide increased price improvement opportunities because it would increase the size available at the best Improvement Order price.²⁰ Further, BSE argues that the AAO will encourage aggressive quoting in the PIP by incenting competitors to put forth their best price to potentially better the AAO Maximum Improvement Price and thus increase their likelihood of allocation. In addition, BSE analogizes the AAO to BOX's Customer PIP Order,²¹ which also is displayed on the BOX Book at a standard increment but contains a penny price that is not broadcast to PIP participants.²² BSE represents that the AAO functionality is being proposed to make it easier for customers to participate in an Improvement Auction, especially non-professional customers who lack the ability to monitor and adjust prices fast enough to be competitive, and who may not have access to a broker that utilizes the CPO function. BSE therefore believes that the AAO functionality will increase competition in the PIP because it will allow more new entrants. Additionally, BSE notes that since Public Customer orders already have priority status in Improvement Auctions pursuant to customer priority rules, the AAO will only incrementally increase the priority available to them.²³

The Commission agrees that the availability of the AAO should increase the ability of Public Customers to participate in Improvement Auctions.²⁴ The Commission also does not believe that the possibility of undisclosed AAO penny interest will give Improvement Auction

²⁰ See BSE Letter, supra note 5, at 2.

²¹ See Securities Exchange Release No. 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004).

²² See BSE Letter, supra note 5, at 2.

²³ See BSE Letter, supra note 5, at 3.

²⁴ BSE represents that only a few OFPs have made CPOs available to non-professional customers due, in large part, to the constraints that are generally associated with the software development an OFP is required to undertake to handle the processing of the CPO. See Notice, supra note 3.

participants a disincentive to enter their best prices and may provide a further incentive to enter their best prices to increase the likelihood of participating in the execution of the order. Further, the AAO functionality provides the potential for increased size available at the best Improvement Price. The Commission therefore believes that the AAO functionality is consistent with the Act.

The Commission further notes that an AAO Limit Order would only be eligible to participate in an Improvement Auction, and thus receive time priority, when the AAO Limit Order equals the NBBO on the opposite side of the Improvement Auction order at the start of the auction. The AAO is similar to the Market Maker Prime (“MMP”) designation in the PIP, in which a market maker that has a quote at the moment the PIP commences that is equal to the NBBO on the same side as the PIP Primary Improvement Order is eligible to be designated MMP for that particular PIP auction and receive priority over other Improvement Orders in the auction.²⁵ The Commission believes that the proposal to give time priority to an AAO that quotes aggressively before an Improvement Order is initiated is consistent with the Act and may provide a further incentive for Public Customers to publicly display their best prices, which would benefit all options market participants.

C. Penny Pilot

The commenter argues that the Penny Pilot Program²⁶ is the appropriate method to approach penny pricing in the options markets, rather than a mechanism that bypasses auction market principles.²⁷ As discussed above, with respect to the commenter’s substantive arguments,

²⁵ The MMP who participates in a PIP will have partial priority over all other competing orders, including the AAO, entered into the PIP at the same limit price. See Chapter V, Section 19(b) of the BOX Rules.

²⁶ The Penny Pilot was approved by the Commission to allow BOX to permit certain option classes to be quoted in pennies on a pilot basis. See Securities Exchange Act Release No. 55155 (January 23, 2007), 72 FR 4741 (February 1, 2007) (SR-BSE-2006-49).

²⁷ See ISE Letter, supra note 4, at 3.

the Commission believes the AAO functionality is consistent with the Act. Further, the Commission notes that the proposal, as amended, is intended to make it easier for Public Customers to participate in the PIP (or other future Improvement Auctions), which already allows trading in penny increments. In addition, pursuant to the amended proposal, AAOs may only be entered in series that are limited to quoting in standard increments greater than one cent. The Commission believes it is consistent with the Act to allow BSE to implement another initiative designed to allow limited trading in penny increments at the same time it participates in the Penny Pilot Program.

D. Accelerated Approval

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 modified by Amendment No. 1, was published for full notice and comment.²⁸ Amendment No. 2, which limits the AAO functionality to Public Customer accounts and in a series for which the standard trading increment is greater than one cent, modifies the proposal in response to issues raised by a commenter. For these reasons, the Commission finds good cause, consistent with Section 19(b)(2) of the Act, to grant accelerated approval to the proposed rule change.

²⁸ See Notice, supra note 3.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁹ that the proposed rule change (SR-BSE-2006-56), as modified by Amendments No. 1 and 2, be, and it hereby is, approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³⁰

Florence E. Harmon
Deputy Secretary

²⁹ 15 U.S.C. 78s(b)(2).

³⁰ 17 CFR 200.30-3(a)(12).