

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51418; File No. SR-BSE-2005-01)

March 23, 2005

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change, and Amendment No. 1 Thereto, by the Boston Stock Exchange, Inc. Relating to the Price Improvement Period Under the Rules of the Boston Options Exchange Facility

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 January 4, 2005, 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 prepared by the BSE. On March 22, 2005, the BSE filed Amendment No. 1 to the proposed rule change.³ 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 BSE proposes to modify the rules of the Boston Options Exchange Facility (“BOX”) that relate to the Price Improvement Period (the “PIP”) to eliminate certain restrictions on the ability of Order Flow Providers, Market Makers, and Public Customers (as defined in Sections 1(46), 1(32), and 1(50), respectively, of Chapter I of the BOX Rules) to participate in the PIP.

Below is the amended text of the proposed rule change. Proposed new language is in *italics*; proposed deletions are in [brackets].

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 superseded and replaced the original filing in its entirety.

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RULES OF THE BOSTON STOCK EXCHANGE

RULES OF THE BOSTON OPTIONS EXCHANGE FACILITY

Trading of options contracts on BOX

Chapter V

Sec. 18 The Price Improvement Period (“PIP”)

(a) through (d) No change.

(e) Options Participants, both OFPs and Market Makers, executing agency orders may designate BOX-Top and marketable limit Customer Orders for price improvement and submission to the PIP. Customer Orders designated for the PIP shall be submitted to BOX with a matching contra order, the “Primary Improvement Order”, equal to the full size of the Customer Order. The Primary Improvement Order shall be on the opposite side of the market than that of the Customer Order and represent a higher bid (lower offer) than that of the National Best Bid Offer (NBBO) at the time of the commencement of the PIP. BOX will not permit a PIP to commence unless at least three (3) Market Makers were quoting in the relevant series at the time an Options Participant submits a Primary Improvement Order to initiate a PIP. BOX will commence a PIP by broadcasting a message to Participants that (1) states that a Primary Improvement Order has been processed; (2) contains information concerning series, size, price and side of market, and; (3) states when the PIP will conclude (“PIP Broadcast”).

- i. The PIP shall be 3 seconds, commencing upon the dissemination of the PIP Broadcast. [During the PIP, Market Makers may submit competing orders, “Improvement Orders”, for only those classes within their appointment. Unless assigned as a Market Maker in the appropriate class,

Options Participants may submit Improvement Orders only in a PIP for which, (1) they have submitted the Primary Improvement Order; (2) they hold a Customer PIP Order, (“CPO”), in accordance with the requirements of Paragraph (g) of this Section 18; or (3) they meet the PIP Proprietary Order (“PPO”) requirements of Paragraph (h) of this Section 18.] During the PIP, Order Flow Providers and Market Makers (except for the Order Flow Provider or Market Maker that submits the relevant Primary Improvement Order) may submit competing orders, “Improvement Orders,” for their own account. Order Flow Providers may submit Improvement Orders for the account of a Public Customer under any type of instruction they wish to accept. Order Flow Providers may also provide access to the PIP on behalf of a Public Customer in the form of a CPO (as set forth in subparagraph (g) below). An Improvement Order submitted to the PIP for the account of a Public Customer, including a CPO, must be identified as a Public Customer Order. [Market Makers and]Options Participants [meeting the foregoing criteria] who submit Improvement Orders for a PIP, including CPOs, shall be deemed “PIP Participants” for that specific PIP only, and may continually submit competing Improvement Orders during that PIP. During the PIP, Improvement Orders shall be disseminated solely to Options Participants.

- ii. The Options Participant who submitted the Primary Improvement Order is not permitted to cancel or to modify the size of its Primary Improvement Order or the Customer Order at any time during the PIP, and may modify

only the price of its Primary Improvement Order by improving it. The subsequent price modifications to a Primary Improvement Order are treated as new Improvement Orders for the sake of establishing priority in the PIP process. Options Participants that are permitted to submit Improvement Orders (as set forth in subparagraph i. above)[Market Makers, except for a Market Maker that submits the relevant Primary Improvement Order,] may: (1) submit competing Improvement Order(s) for any size up to the size of the Customer Order; (2) submit competing Improvement Order(s) for any price equal to or better than the Primary Improvement Order; (3) improve the price of their Improvement Order(s) at any point during the PIP; and (4) decrease the size of their Improvement Order(s) only by improving the price of that order. Improvement Orders may be submitted in one-cent increments.

- iii. At the conclusion of the PIP, the Customer Order shall be matched against the best prevailing order(s) on BOX, in accordance with price/time priority as set forth in Section 16 of this Chapter V, whether Improvement Order(s), including CPO(s)[and PPO(s)], or unrelated order(s) received by BOX during the PIP. Such unrelated orders may include agency orders on behalf of Public Customers, market makers at away exchanges and non-Box Participant broker-dealers, as well as non-PIP proprietary orders submitted by Options Participants.
- iv. The only exceptions to time priority are: (1) no order for a non-market maker broker-dealer account of an Options Participant may be executed

before all Public Customer order(s), whether an Improvement Order, including a CPO, or unrelated, and all non-BOX Participant broker-dealer order(s) at the same price have been filled; (2) as provided in paragraph (f) of this Section 18; and (3) as provided in paragraphs (b) and (c) of Section 19 below. Any portion of an Improvement Order left unfilled shall be cancelled.

(f) The PIP Participant who submitted the Customer Order to the PIP process for price improvement retains certain priority and trade allocation privileges upon conclusion of the PIP, as follows:

- i. In instances in which the Primary Improvement Order as modified (if at all) is matched by or matches any competing Improvement Order(s) and/or non-Public Customers unrelated order(s) at any price level, the PIP Participant retains priority for only forty percent (40%) of any unexecuted portion of the Customer Order available at that price level, notwithstanding the time priority of the Primary Improvement Order, competing Improvement Order(s) or non-Public Customer unrelated order(s). The PIP Participant who submitted the Customer Order to the PIP process will receive additional allocation only after all other orders have been filled at that price level.
- ii. The Primary Improvement Order shall yield priority to certain competing orders in the following circumstances:
 1. When an order for the proprietary account of an OFP is matched by or matches any competing Public Customer order(s), whether

an Improvement Order, including a CPO, or unrelated order(s), or any non-BOX Participant broker-dealer order(s) at any price level, it shall yield priority to them, including any priority provided pursuant to subparagraph f(i), above.

2. When the unmodified Primary Improvement Order for the account of a Market Maker is matched by any competing Public Customer order(s), whether an Improvement Order, including a CPO, or unrelated order, or any non-BOX Participant broker-dealer order(s) at the initial PIP price level, it shall yield priority to all competing Public Customer order(s) or non-BOX Participant broker-dealer order(s), including any priority provided pursuant to subparagraph f(i), above.

3. When the modified Primary Improvement Order for the account of a Market Maker matches any competing Public Customer order(s), whether an Improvement Order, including a CPO, or unrelated order, or any non-BOX Participant broker-dealer order(s) at subsequent price levels, it shall yield priority to all competing Public Customer order(s) or non-BOX Participant broker-dealer order(s), including any priority provided pursuant to subparagraph f(i) above.

iii. In all cases in which the Primary Improvement Order has priority pursuant to the provisions of (i) and (ii) above, it shall be entitled to a trade allocation of at least one (1) contract.

Note: It shall be considered conduct inconsistent with the just and equitable principles of trade for any Options Participant to engage in a pattern of conduct where the Options Participant submits Primary Improvement Orders into the PIP process for 2 contracts or less for the purpose of manipulating the PIP process in order to gain a higher allocation percentage than the Options Participant would have otherwise received in accordance with the allocation procedures set forth in this Section 18.

(g) In addition to Improvement Orders submitted on behalf of Public Customers, OFPs may provide access to the PIP on behalf of a customer that is not a broker-dealer (i.e. Public Customer) in the form of a Customer PIP Order (“CPO”) provided that:

- i. The terms of each CPO shall include a price stated in rounded five cent or ten cent increments, as appropriate, (“standard tick”) at which the order shall be placed in the BOX Book (“BOX Book Reference Price”) as well as a specific price stated in one cent increments (“penny tick”) at which the Public Customer wishes to participate in any PIPs (“CPO PIP Reference Price”) that may occur while his order is on the BOX Book and displayed at the BOX Book Reference Price;
- ii. The terms of each CPO shall include a specific order size (“CPO Total Size”). The number of contracts that may be entered into a PIP must be no greater than the lesser of (a) the CPO Total Size remaining on the BOX Book or (b) the size of the Primary Improvement Order submitted to the PIP;

- iii. In order for the CPO to be eligible for participation in a PIP in the subject options series, the BOX Book Reference Price for a CPO at the time a PIP commences must be equal to the best BOX price (i.e. the BBO).
- iv. The CPO may only participate in a PIP on the same side of the market as the Primary Improvement Order.
- v. Upon initiation of a PIP for which a CPO is eligible to participate pursuant to paragraphs (i)-(iv) above, the OFP who submitted the CPO to the BOX Book must submit a CPO to the PIP at a price which is better than the BOX Book Reference Price and at any price level up to the CPO PIP Reference Price. At any time during the PIP, the OFP may modify the price of the CPO submitted to the PIP to any price level up to the CPO PIP Reference Price.

(h) [Unless assigned as a Market Maker in the appropriate class, Options Participants may enter a PIP Proprietary Order (“PPO”) for their proprietary account in a PIP provided that:

- i. At the commencement of the PIP, they already have an order on the BOX Book for their proprietary account equal to the best BOX price (i.e. the BBO).
- ii. The size of the PPO entered into a PIP must be no greater than the lesser of (a) the total size remaining on the BOX Book for the proprietary order or (b) the size of the Primary Improvement Order submitted to the PIP.
- iii. At any time during the PIP, the Options Participant may improve the price of the PPO submitted to the PIP.]

(i) In cases where an executable unrelated order is submitted to BOX on the same side as the Customer Order, such that it would cause an execution to occur prior to the end of the PIP, the PIP shall be deemed concluded and the Customer Order shall be matched pursuant to Paragraph (e)(iii) of this Section 18, above.

It shall be considered conduct inconsistent with just and equitable principles of trade for any Participant to enter unrelated orders into BOX for the purpose of disrupting or manipulating the Improvement Period process.

(j) Improvement Orders, including CPOs[and PPOs], must be submitted in increments no smaller than one penny (\$.01). Improvement Orders, including CPOs[and PPOs], will be displayed to BOX Options Participants, but will not be disseminated to OPRA.

(k) Improvement Orders may not be executed unless the price is better than the NBBO at the commencement of the PIP, except in the following circumstances:

- i. Where an Options Official determines that quotes from one or more particular markets in one or more classes of options are not reliable, the Options Official may direct the senior person in charge of BOX's Market Control Center to exclude the unreliable quotes from the Improvement Period determination of the NBBO in the particular option class(es). The Options Official may determine quotes in one or more particular options classes in a market are not reliable only in the following circumstances:
 - 1) Quotes Not Firm: A market's quotes in a particular options class are not firm based upon direct communication to the Exchange from the market or the dissemination through OPRA of a message indicating that disseminated quotes are not firm;

- 2) Confirmed Quote Problems: A market has directly communicated to the Exchange or otherwise confirmed that the market is experiencing systems or other problems affecting the reliability of its disseminated quotes.
- ii. The away options exchange posting the NBBO is conducting a trading rotation in that options class.

Supplementary Material to Section 18

01. Initially, and for at least a Pilot Period of eighteen months from the commencement of trading on BOX, there will be no minimum size requirement for Customer Orders to be eligible for the PIP process. During this Pilot Period, BOXR will submit certain data, periodically as required by the Commission, to provide supporting evidence that, among other things, there is meaningful competition for all size PIP orders, that there is significant price improvement for all orders executed through the PIP, and that there is an active and liquid market functioning on BOX outside of the PIP mechanism. Any data which is submitted to the Commission by BOXR will be provided on a confidential basis.

02. With respect to the same series, no PIP will run simultaneously with another PIP, nor will PIPs queue or overlap in any manner.

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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, as amended, and discussed any comments it received on the proposal. 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

The purpose of the proposal would be to eliminate certain restrictions on the ability of Order Flow Providers, Market Makers, and Public Customers (as defined in Sections 1(46), 1(32), and 1(50), respectively, of Chapter I of the BOX Rules) to participate in BOX’s price improvement period, the PIP. After an Order Flow Provider or a Market Maker submits a Customer Order (as defined in Section 1(20) of Chapter I of the BOX Rules) to the PIP, the proposal would permit Order Flow Providers and Market Makers (except for the Order Flow Provider or Market Maker that submits the relevant Primary Improvement Order⁴) to submit competing orders, “Improvement Orders,” for their proprietary account; and, in the case of all Order Flow Providers, to submit Improvement Orders for the account of a Public Customer (as defined in Section 1(19) of Chapter I of the BOX Rules). Improvement Orders may be submitted in one-cent increments at the same price as the Primary Improvement Order or at an improved price, and for any size up to the size of the Customer Order submitted to the PIP.

Currently, to participate in the PIP, unless an Options Participant (as defined in Section 1(40) of Chapter I of the BOX Rules) is assigned as a Market Maker in the relevant class, Options Participants may compete only in a PIP for which: (1) they have submitted the Customer Order to the PIP (through the use of the Primary Improvement Order); (2) they hold a Customer PIP Order (as described below); or (3) they meet the requirements of Section 18(h) of Chapter V of

⁴ When an Options Participant submits a Customer Order to the PIP, the Options Participant also submits a matching contra order, the “Primary Improvement Order,” on the opposite side of the market than that of the Customer Order, and at a higher bid (lower offer) than that of the national best bid or offer (NBBO) at the time of the commencement of the PIP.

the BOX Rules, which, among other things, include the requirement that an Options Participant have an order in the relevant class on the BOX Book (as defined in Section 1(12) of Chapter I of the BOX Rules) for their proprietary account equal to the best BOX price. If an Options Participant is assigned as a Market Maker in the relevant class, the Options Participant is not required to meet any of these requirements to participate in the PIP.

Currently, a Public Customer may participate in a PIP only if it has provided an Order Flow Provider with a Customer PIP Order. A Customer PIP Order includes a specific order size; a price stated in rounded five cent or ten cent increments, as appropriate, at which the order shall be placed in the BOX Book (the “BOX Book Reference Price”); and a specific price stated in one cent increments at which the Public Customer wishes to participate in any PIPs that may occur while his order is on the BOX Book. Because of the inclusion of the BOX Book Reference Price, a Customer PIP Order is a hybrid of an instruction and an order. While a Customer PIP Order participates in a PIP, the order is removed from the BOX Book. Currently, a Customer PIP Order can participate in a PIP only if the BOX Book Reference Price is equal to the best BOX price at the time a PIP commences.

BSE proposes to allow Order Flow Providers to provide access to the PIP on behalf of a Public Customer not only through Customer PIP Orders, but through any type of instruction they wish to accept, so long as the Improvement Order (like a Customer PIP Order) is identified as a Public Customer Order when it is submitted to the PIP. This identification is necessary for purposes of allocation priority. Customer PIP Orders would no longer be the only Improvement Orders that could be Public Customer Orders.

BSE also proposes to eliminate the requirement that Options Participants, unless assigned as a Market Maker in the appropriate class, have an order on the BOX Book for their proprietary

account equal to the best BOX price before a PIP commences to participate in the PIP. All references to the PIP Proprietary Order would be eliminated from the BOX Rules because all Options Participants (except for the Order Flow Provider or Market Maker that submits the relevant Primary Improvement Order to the PIP) could submit Improvement Orders for their proprietary accounts without restrictions, and this separate order type would no longer be necessary.

The Commission recently approved the proposal of the International Securities Exchange (the "ISE") to establish a price improvement mechanism (the "PIM").⁵ The ISE's rules relating to the PIM do not include the restrictions discussed above, and some of BOX's Order Flow Providers have requested that BSE modify BOX's rules in this manner to remain competitive with the ISE.

BSE believes that the elimination of the restrictions on when Options Participants and Public Customers can compete in the PIP would increase the opportunity for them to participate in the PIP, and could lead to more robust competition in the PIP. BSE does not believe that the elimination of these restrictions would have a negative impact on the incentives for BOX Market Makers to quote competitively. The primary incentives for BOX Market Makers to quote competitively are BOX's general price/time priority rules and the trade allocation priority granted to the Market Maker Prime. A Market Maker Prime is a Market Maker who has a quote that is equal to the NBBO on the same side of the market as the Primary Improvement Order at the initiation of the PIP. If more than one Market Maker meets this criterion, the Market Maker whose quote has time priority would be the Market Maker Prime for that PIP.

⁵ See Securities Exchange Act Release No. 50819 (December 8, 2004); 69 FR 75093 (December 15, 2004) ("PIM Approval Order").

A Market Maker designated as the Market Maker Prime⁶ would have priority over all other Improvement Orders and unrelated orders up to one-third of the portion of the Customer Order remaining at the price level of the Market Maker Prime's Improvement Order. This priority encourages Market Makers to quote aggressively.⁷

BSE proposes to retain the Customer PIP Order because it provides Public Customers with the ability to have an order on the BOX Book and participate in a PIP without risking double liability.

2. Statutory Basis

The Exchange believes that the proposal, as amended, is consistent with the requirements of Section 6(b) of the Act,⁸ in general, and Section 6(b)(5) of the Act,⁹ in particular, in that it is designed 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 protect investors and the public interest.

⁶ This special priority, however, would apply only if the Market Maker Prime enters an Improvement Order during the PIP.

⁷ In its approval of BOX, the Commission stated that it “believes that the BSE’s proposal to give priority to a Market Maker who quotes aggressively before a PIP is initiated, is consistent with the Act and may provide a further incentive for Market Makers to publicly display their best quotes, which would benefit all options market participants.” See Securities Exchange Act Release No. 49068 (January 13, 2004); 69 FR 2775 (January 20, 2004).

⁸ 15 U.S.C. 78f(b).

⁹ 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, as amended, will result in 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 neither solicited nor received written comments with respect to the proposed rule change, as amended.

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, as amended; or
- (B) institute proceedings to determine whether the proposed rule change, as amended, 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, 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-2005-01 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-BSE-2005-01. 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, as amended, that are filed with the Commission, and all written communications relating to the proposed rule change, as amended, 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-2005-01 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.¹⁰

Margaret H. McFarland
Deputy Secretary

¹⁰ 17 CFR 200.30-3(a)(12).