

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51597; File No. SR-BSE-2004-51)

April 21, 2005

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change, and Amendment Nos. 1, 2, and 3 Thereto, by the Boston Stock Exchange, Inc. Relating to the Trading of Market Orders on the Boston Options Exchange

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 15, 2004, 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 Exchange. On January 5, 2005, the Exchange filed Amendment No. 1 to the proposed rule change. On April 19, 2005, the Exchange filed Amendment No. 2 to the proposed rule change.³ On April 21, 2005, the Exchange filed Amendment No. 3 to the proposed rule change.⁴ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 2 superseded and replaced the original filing and Amendment No. 1 in their entirety.

⁴ In Amendment No. 3, BSE made several conforming and technical changes to the proposed rule text.

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 allow market orders to trade on BOX. The text of the proposed rule change is set forth below.

Italics indicate additions; brackets indicate deletions.⁵

RULES OF THE BOSTON STOCK EXCHANGE

RULES OF THE BOSTON OPTIONS EXCHANGE FACILITY

Trading of options contracts on BOX

CHAPTER V. DOING BUSINESS ON BOX

Sec. 1 through Sec. 8 No change.

Sec. 9 Opening the Market

The following rules are in effect until August 6, 2005:

(a) Pre-Opening Phase. For some period of time before the opening in the underlying security (as determined by BOXR but not less than one hour and distributed to all BOX Participants via regulatory circular from BOXR), the BOX Trading Host will accept orders and quotes. During this period, known as the Pre-Opening Phase, orders and quotes are placed on the BOX Book but do not generate trade executions. Complex Orders and contingency orders (except "Market-on-Opening", Minimum Volume, and Fill and Kill orders) do not participate in the opening and are not accepted by the BOX Trading Host during this Pre-Opening Phase.

⁵ At the request of the BSE, the Commission staff has made several corrections to the rule text. Telephone conversation between Annah Kim, Chief Regulatory Officer, BOX, et al., and Ira Brandriss, Assistant Director, Division of Market Regulation ("Division"), et al., on April 21, 2004.

BOX-Top Orders and Price Improvement Period orders are not accepted during the Pre-Opening Phase.

(b) Calculation of Theoretical Opening Price. From the time that the BOX Trading Host commences accepting orders and quotes at the start of the Pre-Opening Phase, the BOX Trading Host will calculate and provide the Theoretical Opening Price (“TOP”) for the current resting orders and quotes on the BOX Book during the Pre-Opening Phase. The TOP is that price at which the Opening Match would occur at the current time, if that time were the opening, according to the Opening Match procedures described in paragraph (e) below. The quantity that would trade at this price is also calculated. The TOP is re-calculated and disseminated every time a new order or quote is received, modified or cancelled and where such event causes the TOP price or quantity to change.

A TOP can only be calculated if an opening trade is possible. An opening trade is possible if: i) the BOX Book is crossed (highest bid is higher than the lowest offer) or locked (highest bid equals lowest offer), or ii) there are Market or Market-on-Opening Orders in the BOX Book and at least one order or quote on the opposite side of the market.

(c) Broadcast Information During Pre-Opening Phase. The BOX Trading Host will disseminate information to all BOX Participants about resting orders in the BOX Book that remain from the prior business day and any orders or quotes sent in before the Opening Match. This information will be disseminated in the usual BOX format of five best limits and associated quantity, aggregating all orders and quotes at each price level. This broadcast will also include the TOP and the quantity associated with the TOP. Any orders or quotes which are at a price better (i.e. bid higher or offer lower) than the TOP, as well as all Market and Market-on-Opening orders will be shown only as a total quantity on the BOX Book at a price equal to the TOP.

(d) **Market Maker Obligations During Pre-Opening Phase.** BOX Market Makers holding an assignment on a given options class are obliged, as part of their obligations to ensure a fair and orderly market, to provide continuous two-sided quotes according to the BOX minimum standards commencing with the minute preceding the scheduled opening of the market for the underlying security.

(e) **Opening Match.**

(i) Complex Orders and contingency orders do not participate in the Opening Match or in the determination of the opening price. The BOX Trading Host will establish the opening price at the time of the Opening Match. The opening price is the TOP at the moment of the Opening Match. The BOX Trading Host will process the series of a class in a random order, starting at the first round minute after the opening for trading of the underlying security in the primary market, and at each round minute thereafter. If the opening of a particular class is to occur within 15 seconds of the next round minute, the opening of that class will take place at the next subsequent round minute after the round minute that is 15 or less seconds away (i.e. within 75 seconds). The TOP/opening price of a series is the “market-clearing” price which will leave bids and offers which cannot trade with each other. In determining the priority of orders to be filled, the BOX Trading Host will give priority to Market Orders first, then to Market-on-Opening orders [first], then to Limit Orders whose price is better than the opening price, and then to resting orders on the BOX Book at the opening

price. One or more series of a class may not open because of conditions cited in paragraph (f) of this Section 9.

(ii) The BOX Trading Host will determine a single price at which a particular option series will be opened. BOX will calculate the optimum number of options contracts that could be matched at a price, taking into consideration all the orders on the BOX Book.

- 1) The opening match price is the price which will result in the matching of the highest number of options contracts.
- 2) Should two or more prices satisfy the maximum quantity criteria, the price which will leave the fewest resting contracts in the BOX Book will be selected as the opening match price.
- 3) Should there still be two or more prices which meet both criteria in subparagraphs (1) and (2), the price which is closest to the previous day's closing price will be selected as the opening match price. For new classes in which there is no previous day's closing price, BOX will utilize the price assigned to the class by BOX at the time the class was created ("reference price").

(f) As the Opening Match price is determined by series, the BOX Trading Host will proceed to move the series from the Pre-Opening Phase to the continuous or regular trading phase and disseminate to OPRA and to all Options Participants the opening trade price, if any. At this point, the BOX trading system is open for trading and all orders and quotes are accepted and processed according to the BOX trading rules. When the BOX Trading Host cannot determine an opening price, but none of the

reasons exist for delaying an opening as outlined in paragraph (g) of this Section 9, below, the series will nevertheless move from Pre-Opening Phase to the continuous trading phase.

(g) The BOX Trading Host will not open a series if one of the following conditions is met:

- i. The opening price is not within an acceptable range as determined by the MRC, and will be announced to all BOX Participants via the Trading Host. (In making this determination the MRC will consider, among other factors, all prices that exceed a variance greater than [of] either \$.50 or 20% to the previous day's closing price.)
- ii. There is a Market Order, Market-on-Opening order or quote with no corresponding order or quote on the opposite side.

(h) If one of the conditions in paragraph (g) of this Section 9 is met, the MRC will not open the series but will send a RFQ. MRC will delay the opening of the series until such time as responses to the RFQ from the BOX Market Makers assigned to the class, or other interested trading parties, have been received and booked by the BOX Trading Host and the consequent opening price is deemed compatible with an orderly market.

(i) MRC may order a deviation from the standard manner of the opening procedure, including delaying the opening in any option class, when it believes it is necessary in the interests of a fair and orderly market.

(j) The procedure described in this Section 9 may be used to reopen a class after a trading halt.

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Sec. 14 Order Entry

(a) through (b) No change.

(c) The following types of orders may be submitted to the Trading Host:

i. through iii. No change.

iv. Market Order. Market Orders submitted to BOX are executed at the best price obtainable for the total quantity available when the order reaches the BOX market. Any remaining quantity is executed at the next best price available for the total quantity available. This process continues until the Market Order is fully executed. Prior to execution at each price level, Market Orders are filtered pursuant to the procedures set forth in Chapter V, Section 16(b) of these Rules to avoid trading through the NBBO.

At the opening, Market Orders have priority over Market-on-Opening Orders and Limit Orders. In the case where the lowest offer for any options contract is \$.05, and an Options Participant enters a Market Order to sell that series, any such Market Order shall be considered a Limit Order to sell at a price of \$.05.

(d) Where no order type is specified, the Trading Host will reject the order.

i. The following designations can be added to one or both of the order types referred to in paragraph (c) above:

1) through 3) No change.

- 4) Minimum Volume (MV). An MV designation can be added to [both] Limit Orders, [and] BOX Top Orders, and Market Orders. MV orders will only be executed if the specified minimum volume is immediately available to trade (at the specified price or better in the case of Limit Orders). If this is not the case the order will be automatically cancelled by the Trading Host. In the case of Limit Orders, where a volume equal to or greater than the specified minimum volume of an MV order trades, the residual volume will be filtered against trading through the NBBO according to the procedures set forth in Section 16(b) of this Chapter V and, if applicable, placed on the BOX Book. In the case of BOX-Top Orders, where a volume equal to or greater than the specified minimum volume of an MV order trades, the residual volume will be converted to a Limit Order at the price at which the BOX-Top Order was executed pursuant to Section 14(c)(ii) of this Chapter V and will be filtered against trading through the NBBO according to the procedures set forth in Section 16(b) of this Chapter V and, if applicable, placed on the BOX Book. In the case of Market Orders, where a volume equal to or greater than the specified minimum volume of an MV order trades, the residual volume will be filtered against trading through the NBBO according to the procedures set forth in Section 16(b) of this Chapter V and, if applicable, executed with any orders on the BOX Book.

(e) through (i) No change.

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Sec. 16 Execution and Price/Time Priority

(a) No change.

(b) Filtering of BOX In-Bound Orders to Prevent Trade-Throughs.

i. No change.

ii. If the order is a BOX-Top Order, the Trading Host will handle the order in the following manner:

- 1) In the case where the best price on the BOX Book on the opposite side of the market from the BOX-Top order is equal to the NBBO, the BOX-Top Order will be executed for all the quantity available at this price. Any remaining quantity will be converted to a Limit Order at this execution price pursuant to Section 14(c)(ii) of this Chapter V and filtered as described in subparagraph b(iii) below.
- 2) In the case where the best price on the BOX Book on the opposite side of the market from the BOX-Top Order is not equal to the NBBO, the BOX-Top Order will be converted to a Limit Order for its total quantity at the then current NBBO pursuant to Section 14(c)(ii) of this Chapter V and filtered as described in subparagraph b(iii) below.

If the Order is a Market Order, the Trading Host will handle the order in the following manner:

- 1) In the case where the best price on the BOX Book on the opposite side of the market is equal to the NBBO, the Market Order will be executed for all the quantity available at this price. Any remaining quantity will be filtered as described in subparagraph b(iii) below.
- 2) In the case where the best price on the BOX Book on the opposite side of the market from the Market Order is not equal to the NBBO, the Market Order will be filtered as described in subparagraph b(iii) below.

iii. The Trading Host will filter the relevant orders as follows:

The filter will determine if the order is executable against the NBBO (an order is deemed “executable against the NBBO” when, in the case of an order to sell(buy), its limit price is equal to or lower(higher) than the best bid(offer) across all options exchanges. By definition, a BOX-Top Order or a Market Order is executable against the NBBO).

- 1) If the order is not executable against the NBBO, the order will be placed on the BOX Book. However, if the order is a P or P/A Order, and not executable against the NBBO, it will be immediately cancelled pursuant to Chapter XII of these Rules.
- 2) If the order is executable against the NBBO, the filter will determine whether there is a quote on BOX that is equal to the NBBO.

- a. If there is a quote on BOX that is equal to the NBBO, then the order will be executed against the relevant quote. Any remaining quantity of the order is exposed on the BOX Book at the NBBO for a period of three seconds. If the order is not executed during the three second exposure period, then the order will be handled by the Trading Host pursuant to subparagraph b(iii)(2)(c) below. Pursuant to Chapter XII, Section 2(c)-(d) of these Rules, in the case of a P/A Order, if the size of the P/A Order is larger than the Firm Customer Quote Size, or, in the case of a P Order, if the size of the P Order is larger than the Firm Principal Quote Size, and any quantity remains after execution against the relevant quote, then such remaining quantity is exposed on the BOX Book at the NBBO for a period of three seconds. Any quantity remaining on the BOX Book after the three second exposure period will be cancelled. BOX will inform the sending Participant Exchange of the amount of the order that was executed and the amount, if any, that was cancelled;

- or -

- b. If there is not a quote on BOX that is equal to the NBBO, then the order is exposed on the BOX Book at the NBBO for a period of three seconds, unless such order is a P or

P/A Order. If the order is a P or P/A order it will be immediately cancelled pursuant to the Chapter XII of these Rules. If the order is not executed during the three second exposure period, then the order will be handled by the Trading Host pursuant to subparagraph b(iii)(2)(c) below.

c. At the end of the three second exposure period, any unexecuted quantity will be handled by the Trading Host in the following manner:

1. If the best BOX price is now equal to the NBBO, the remaining unexecuted quantity will be placed on the BOX Book and immediately executed against that quote. Any remaining quantity will be i) in the case of Public Customer orders, sent as P/A order(s) to the exchange displaying the NBBO, or ii) in the case of market maker or proprietary broker-dealer orders, returned to the submitting Options Participant; or
2. If the best BOX price is not equal to the NBBO, then any remaining unexecuted quantity will be i) in the case of Public Customer orders, sent as P/A Order(s) to the exchange displaying the NBBO, or ii) in the case of market maker or proprietary

broker-dealer orders, returned to the submitting
Options Participant.

iv. Notwithstanding the foregoing, if an Order is submitted while a PIP is in progress, and the Order is in the same series and on the opposite side of the Customer Order submitted to the PIP (the “PIP Order”), under the circumstances set forth in Section 18(i) of this Chapter V, the Order will be immediately executed against the PIP Order up to the lesser of (a) the size of the PIP Order, or (b) the size of the Order, at a price equal to either (i) one penny better than the NBBO or (ii) the NBBO. The remainder of the Order, if any, continues to be filtered as set forth in this Section 16(b).

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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 Orders, Market Orders, and marketable limit Customer Orders for price improvement and submission to the PIP. Customer Orders designated for the PIP (PIP Orders) shall be submitted to BOX with a matching contra order, the “Primary Improvement Order”, equal to the full size of the [Customer] PIP Order. The Primary Improvement Order shall be on the opposite side of the market than that of the [Customer] PIP 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. No change.
- 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] PIP 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. 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] PIP 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.
- iii. At the conclusion of the PIP, the [Customer] PIP 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 (excluding unrelated orders that were immediately

executed during the interval of the PIP). Such unrelated orders may include agency orders on behalf of Public Customers, market makers at away exchanges and non-BOX[Box] Participant broker-dealers, as well as non-PIP proprietary orders submitted by Options Participants.

iv. No change.

(f) through (h) No change.

(i) In cases where an [executable] unrelated order is submitted to BOX on the same side as the [Customer] PIP 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] PIP Order shall be matched pursuant to paragraph (e)(iii) of this Section 18, above.

Specifically, the submission to BOX of a BOX-Top Order or Market Order on the same side as a PIP Order will prematurely terminate the PIP when, at the time of the submission of the BOX-Top Order or Market Order, the best Improvement Order is equal to or better than the NBBO. (If a BOX-Top Order or Market Order is a buy order, the best Improvement Order is better than the NBBO when the price of the best Improvement Order is lower than the National Best Offer. If a BOX-Top Order or a Market Order is a sell order, the best Improvement Order is better than the NBBO when the price of the best Improvement Order is higher than the National Best Bid.) Following the execution of the PIP Order, any remaining Improvement Orders are cancelled and the BOX-Top Order or Market Order is filtered pursuant to Section 16(b) of this Chapter V.

In cases where an unrelated order is submitted to BOX on the opposite side of the PIP Order, such that it would cause an execution to occur prior to the end of the PIP as set forth below, the unrelated order shall be immediately executed against the PIP Order up to the lesser

of (a) the size of the PIP Order, or (b) the size of the unrelated order, at a price equal to either (i) one penny better than the NBBO, if the best BOX price on the opposite side of the market from the unrelated order is equal to the NBBO at the time of execution, or (ii) the NBBO. The remainder of the unrelated order, if any, shall be filtered pursuant to Section 16(b) of this Chapter V. The remainder of the PIP Order, if any, shall be executed at the conclusion of the PIP auction pursuant to Paragraph (e)(iii) of this Section 18, above.

Specifically, a BOX-Top Order or a Market Order on the opposite side of a PIP Order will immediately execute against the PIP Order when, at the time of the submission of the BOX-Top Order or Market Order, the best Improvement Order is equal to or better than the NBBO. (If a BOX-Top Order or Market Order is a buy order, the best Improvement Order is better than the NBBO when the price of the best Improvement Order is lower than the National Best Offer. If a BOX-Top Order or a Market Order is a sell order, the best Improvement Order is better than the NBBO when the price of the best Improvement Order is higher than the National Best Bid.)

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) through (k) No change.

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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 Exchange 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 Exchange 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 allow Market Orders to trade on BOX. BSE notes that all of the other options exchanges trade market orders.⁶ Currently, BOX has two order types which are similar to the proposed Market Order: Market-on-Opening Orders, which are valid only during the pre-opening and opening match phases, and BOX-Top Orders, which may be submitted only during the continuous trading phase. The majority of BOX's current (and prospective) order flow providers ("OFPs") have requested the ability to trade market orders on BOX because their technology is designed for the use of market orders and their customers prefer market orders over BOX-Top Orders. BOX wishes to accommodate and attract order flow from these OFPs. Indeed, many OFPs are reluctant to send their Customer Orders to BOX without this order type, thereby depriving many investors of the possibility of price improvement through BOX's price improvement mechanism, formally referred to as the Price Improvement Period ("PIP").

BOX's Market-on-Opening Orders are executed on the market opening at the best price available in the market until all volume (required to fill the order) on the opposite side of the market has been traded or the order quantity has been exhausted. Any residual volume left after

⁶ See American Stock Exchange Rule 950(b), Chicago Board Options Exchange Rule 6.53(a), International Securities Exchange Rule 715(a), Pacific Exchange Rule 6.62, and Philadelphia Stock Exchange Rule 1066(a).

part of a Market-on-Opening Order has been executed is automatically converted to a limit order at the price at which the original Market-on-Opening Order was executed.

BOX-Top Orders are executed at the best price available in the market for the total quantity available from any contra bid (offer). In general, any residual volume left after part of a BOX-Top Order has been executed is automatically converted to a limit order at the price at which the original BOX-Top Order was executed.

Similar to these order types, Market Orders would be executed at the best price available in the market for the total quantity available from any contra bid (offer). If the full quantity of a Market Order could not be executed at the initial execution price, the remaining quantity of the Market Order would then execute at the next best price available from any contra bid (offer), and so on, until the Market Order was fully executed. To avoid trading through the national best bid or offer (“NBBO”), Market Orders would be filtered prior to execution at each price level pursuant to the procedures set forth in Chapter V, Section 16(b) of the BOX Rules.

During the opening, Market Orders will have priority over Market-on-Opening and Limit Orders.

BSE wishes to clarify how Market Orders would be treated in the following situations:

Market Order Entered When the Lowest Offer is \$.05

In the case where the lowest offer for any options contract is \$.05, and a BOX participant enters a Market Order to sell that series, any such Market Order shall be considered a Limit Order to sell at a price of \$.05.

Market Order Designated as a Minimum Volume Order

A Market Order could be designated as a minimum volume (MV) order and would only be executed if the specified minimum volume is immediately available to trade. If a volume

equal to or greater than the specified minimum volume of an MV order trades, the residual volume would be filtered against trading through the NBBO according to the procedures set forth in Section 16(b) of Chapter V of the BOX Rules and, if applicable, executed with any orders on the BOX Book.

Market Order Entered During a PIP

In general, the BOX PIP is a three-second auction starting at a price better than the current NBBO during which BOX Participants compete to participate in the execution of the Customer Order submitted to the PIP (“PIP Order”) by submitting specially designated orders called Improvement Orders in one penny increments that are valid only in the PIP process. If a Market Order is submitted to BOX during a PIP that is in the same series as the PIP Order, under certain circumstances the submission of the Market Order may prematurely terminate the PIP, or the Market Order may immediately execute against the PIP Order at the NBBO or better. In this regard, Market Orders are treated like BOX-Top Orders, and BSE is taking this opportunity to clarify in the BOX Rules the treatment of BOX-Top Orders in the same circumstances.

Premature Termination

The submission to BOX of a Market Order on the same side as a PIP Order will prematurely terminate the PIP when, at the time of the submission of the Market Order, the best Improvement Order is equal to or better than the NBBO. If a Market Order is a buy order, the best Improvement Order is better than the NBBO when the price of the best Improvement Order is lower than the National Best Offer. If a Market Order is a sell order, the best Improvement Order is better than the NBBO when the price of the best Improvement Order is higher than the National Best Bid. When the PIP is terminated, the PIP Order is matched against the best prevailing orders on BOX (whether Improvement Orders or unrelated orders received by BOX

during the PIP⁷), pursuant to Paragraph (e)(iii) of Section 18 of Chapter V of the BOX Rules. Then the Market Order is filtered pursuant to Paragraph (b) of Section 16 of the BOX Rules.

Under these circumstances, allowing the PIP to continue would violate BOX's priority rules. For example, assume the NBBO and the best BOX price 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 a Market Order to buy 20 contracts is submitted to BOX. If the PIP continued, the Market Order would have been executed at \$2.10, a price that would have violated BOX's priority rules because the best Improvement Order at \$2.07 is at a better price than \$2.10. On BOX, even though Improvement Orders may only execute against PIP Orders, the priority rules still apply, and no order can be executed at a price worse than the best price available to another order. Therefore, the PIP must terminate, the PIP Order must be executed in full, and any left over Improvement Orders must be cancelled immediately before the Market Order is executed. The result would be the same regardless if the Market Order was to buy 10 contracts or to buy 30 contracts.

To demonstrate a different scenario, assume the NBBO and the best BOX price 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 the NBBO changes to \$2.00 bid - \$2.05 offer, but the BBO stays the same. Then a Market Order to buy 20 contracts is submitted to BOX. Pursuant to BOX's NBBO filter, the

⁷ Excluding unrelated orders that were immediately executed during the interval of the PIP, as described below.

Market Order would be exposed internally on BOX for three seconds at \$2.05, and become the best BOX bid. Currently, there is no order on BOX that the Market Order could execute against, including the PIP Order, since they are on the same side. Therefore, the PIP may continue.

However, if the price of the best Improvement Order had been \$2.05 (or lower) when the NBBO changed, the submission of a Market Order would cause the PIP to prematurely terminate because the submission of any additional Improvement Orders at better prices would result in a trade-through of the best BOX bid (the exposed Market Order) when the PIP Order was executed at the end of the PIP.

Immediate Execution

A Market Order on the opposite side of a PIP Order will immediately execute against the PIP Order when, at the time of the submission of the Market Order, the best Improvement Order is equal to or better than the NBBO. If a Market Order is a buy order, the best Improvement Order is better than the NBBO when the price of the best Improvement Order is lower than the National Best Offer. If a Market Order is a sell order, the best Improvement Order is better than the NBBO when the price of the best Improvement Order is higher than the National Best Bid. The Market 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 Market Order, at a price equal to either (i) one penny better than the NBBO, if the best BOX price on the opposite side of the market from the Market Order is equal to the NBBO at the time of the execution, or (ii) the NBBO. The remainder of the Market Order, if any, is filtered pursuant to Section 16(b) of Chapter V of the BOX Rules. The remainder of the PIP Order, if any, continues in the PIP process.⁸

⁸ BSE believes these execution prices are consistent with BOX's priority rules. When the best BOX price on the opposite side of the market from the Market Order is equal to the

Under these circumstances, allowing the PIP to continue without immediately executing the Market Order against the PIP Order would violate BOX's priority rules. For example, assume the NBBO and the best BOX price 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 Market Order to sell 20 contracts is submitted to BOX. If the Market Order did not immediately execute against the PIP Order, it would have been executed at \$2.00 with the best BOX bid which would violate BOX's priority rules because the PIP Order, not the best BOX bid, has priority for the best price. Furthermore, the Market Order would not be available to execute against the PIP Order at the end of the PIP. The PIP Order could have missed the opportunity to receive an execution at \$2.01.

Assume the same situation as described above, except that a Market Order to sell 30 contracts is submitted to BOX. The Market Order would be partially executed against the PIP Order at \$2.01 and the remainder of the Market Order (10 contracts) would be filtered pursuant to Section 16(b) of Chapter V of the BOX Rules. If the Market Order was a Market Order to sell 10 contracts, the Market 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.

To demonstrate a different scenario, assume the NBBO in the relevant series is \$2.05 bid - \$2.10 offer, the best BOX price 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

NBBO at the time of execution, executing the Market Order at the NBBO would violate the time priority of the order on the BOX book with the best BOX price.

the PIP interval, Improvement Orders are submitted to the PIP until the price of the best Improvement Order is \$2.07. Then, assume a Market Order to sell 20 contracts is submitted to BOX. If the Market Order did not immediately execute against the PIP Order, it would have been exposed internally on BOX for three seconds at \$2.05. If the Market Order was executed at \$2.05 during this three second exposure period against any order other than the PIP Order, this would violate BOX's priority rules because the PIP Order has priority and is entitled to the better price. Therefore, the Market Order immediately executes against the PIP Order at \$2.05. However, if the price of the best Improvement Order is \$2.04, the option of immediately executing the Market Order against the PIP Order at \$2.05 is not available because the PIP Order is already guaranteed a better execution at \$2.04, pursuant to the best Improvement Order, and therefore the PIP continues.

Related Amendments

Currently, the BOX Rules address the treatment of unrelated orders on the same side as a PIP Order, but do not address the treatment of unrelated orders on the opposite side of a PIP Order. BSE proposes to add subparagraph (b)(iv) to Section 16 of Chapter V of the BOX Rules and to amend Paragraph (i) of Section 18 of Chapter V of the BOX rules to address the treatment of unrelated orders on the opposite side of a PIP Order, as described above. BSE also proposes to eliminate the term "executable" from Paragraph (i) of Section 18 of Chapter V of the BOX rules because this term is not clearly defined. BSE proposes to specify when a Market Order (or BOX-Top Order) would immediately execute against a PIP Order, or cause the PIP to prematurely terminate.⁹

⁹ BSE intends to file a proposal to clarify when Limit Orders would immediately execute against a PIP Order, or cause the PIP to prematurely terminate.

Paragraph (b) of Section 16 of Chapter V of the BOX Rules describes how inbound orders to BOX are filtered to avoid trading-through the NBBO. BOX proposes to add subparagraph (iv) to clarify that at each step in the filtering process, under certain circumstances if an order (including a Market Order) is an unrelated order on the opposite side of a PIP Order, the order will be immediately executed against the PIP Order as described above, and that any remaining quantity will continue in the filtering process as set forth in Paragraph (b) of Section 16 of Chapter V of the BOX Rules.

BSE also proposes to amend Paragraph (e)(iii) of Section 18 of Chapter V of the BOX Rules to specifically exclude unrelated orders that were immediately executed during the interval of a PIP from the list of orders that PIP Orders are matched against at the conclusion of the PIP.

2. Statutory Basis

The Exchange believes that the proposal, as amended, is consistent with the requirements of Section 6(b) of the Act,¹⁰ in general, and Section 6(b)(5) of the Act,¹¹ in particular, in that the proposal 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.

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.

¹⁰ 15 U.S.C. 78f(b).

¹¹ 15 U.S.C. 78f(b)(5).

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.

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-2004-51 on the subject line.

Paper Comments:

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

All submissions should refer to File Number SR-BSE-2004-51. 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-2004-51 and should be submitted on or before [insert date 21 days from date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹²

Margaret H. McFarland
Deputy Secretary

¹² 17 CFR 200.30-3(a)(12).