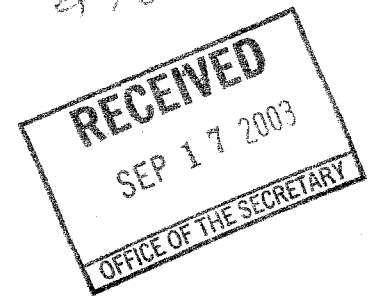


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**Meyer S. Frucher**  
Chairman and Chief Executive Officer

September 12, 2003



Mr. Jonathan G. Katz  
Secretary  
U.S. Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, DC 20549-0609

**Re: Proposal by the Boston Stock Exchange, Inc. to Establish the Boston Options Exchange; SR-BSE-2002-15, Amendment No. 3**

Dear Mr. Katz:

The Philadelphia Stock Exchange, Inc. (“Phlx”) welcomes the opportunity to offer our comments to the Securities and Exchange Commission (“Commission”) on the above-referenced filing, in which the Boston Stock Exchange, Inc. (“BSE”) amends its original proposal to establish a new trading facility for the trading of standardized options – the Boston Options Exchange (“BOX”).

As discussed below, the Phlx does not believe that SR-BSE-2002-15, Amendment No. 3 (the “Amended Proposal”) complies with the requirements for approval of a self-regulatory organization (“SRO”) proposed rule change, as set forth Section 19 of the Securities Exchange Act of 1934, as amended (“Exchange Act”)<sup>2</sup> and the rules thereunder. In addition, the Amended Proposal, as published, does not satisfy the standards set forth in Sections 6(b)(5),<sup>3</sup> 6(b)(8),<sup>4</sup> and 11A<sup>5</sup> of the Exchange Act, because it imposes an inappropriate burden on competition, permits unfair discrimination between brokers and dealers, and is at odds with the fundamental goals of a National Market System.

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<sup>1</sup> The BSE originally filed for Commission approval of the BOX in January, 2003. *See* Securities Exchange Act Release No. 47186 (January 14, 2003), 68 FR 3062 (January 22, 2003) (SR-BSE-2002-15) (the “Original Release”). The Exchange submitted a comment letter concerning the Original Release in February, 2003. *See* Letter from Meyer S. Frucher, Chairman, Phlx, to Jonathan G. Katz, Secretary, Commission, dated February 12, 2003 (the “Phlx Comment Letter”).

<sup>2</sup> 15 U.S.C 78a et seq.

<sup>3</sup> 15 U.S.C. 78f(b)(5). We also note that the proposal is inconsistent with Section 3(f) of the Exchange Act, which requires that the Commission consider, in addition to the protection of investors, whether an SRO’s proposed rule change will promote efficiency, competition and capital formation. 15 U.S.C 78c(f).

<sup>4</sup> 15 U.S.C. 78f(b)(8).

<sup>5</sup> 15 U.S.C. 78k-1.

The Phlx believes that the Amended Proposal does not adequately address the issues raised in the Phlx Comment Letter, and by other commentators, concerning the practice of internalization of options orders by Order Flow Providers (“OFPs”)<sup>6</sup> which, notwithstanding the changes proposed in the Amended Proposal (as described more fully below), the BOX is obviously designed to promote.<sup>7</sup> The Phlx is not yet convinced that the potential hazards of internalization, including the potential conflict of interest concerns, merit banning internalization and participation guarantees *altogether*. Nonetheless, the Phlx recognizes that, taken to an extreme, internalization practices could be highly detrimental to the securities markets, and, thus, the Phlx would endorse further study of the matter by the Commission and the Intermarket Surveillance Group. In the interim, in light of former Chairman Pitt’s indictment of broker-dealer internalization practices in the listed options market, the Commission cannot, consistent with former Chairman Pitt’s views, approve the Amended Proposal because it creates a market structure that permits – and indeed encourages – internalization more so than any other exchange.

The controversial practice of internalization would effectively be validated by the Commission if it were to approve the Amended Proposal as currently presented, without the Commission having adopted any official position on the issue. In April, 2003, the Director of the Commission’s Division of Market Regulation announced at an industry event the Division’s intention to publish a concept release articulating a view on the issue of internalization in the options markets and requesting public comment, which was confirmed in Chairman Donaldson’s May 29, 2003 letter to the Exchange.<sup>8</sup> If the Commission were to approve the Amended Proposal before establishing a general policy on internalization through the concept release and public comment, the result could be a Commission-approved system that is inconsistent with whatever policy it eventually settles on. Accordingly, the Commission should not approve the Amended Proposal until after it has published that concept release and harvested public comment on it.

**If**, on the other hand, the Commission has resolved and rationalized the concerns raised in the options industry over the issue of internalization, such resolution and rationale should be shared with the industry and the investing public, so that all participants in the National Market System can react accordingly on a level playing field.

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<sup>6</sup> Under the Amended Proposal, the terms “Order Flow Provider” and “OFP” would mean those Options Participants representing as agent Customer Orders on BOX and those non-Market Maker Participants conducting proprietary trading. *See* proposed BOX Rules, Chapter I, Section 1(a)(46).

<sup>7</sup> In the Phlx Comment Letter, the Phlx stated that it “would find it incomprehensible for the Commission to approve at this time the BOX proposal – a trading system *specifically designed* to promote internalization of customer orders – in light of Chairman Pitt’s strong criticisms of the practice of internalization in the listed options markets.” *See* Letter from The Honorable Harvey L. Pitt, Chairman, Commission, to Meyer S. Frucher, Chairman, Phlx, dated January 24, 2003 (“January 24th Letter”).

<sup>8</sup> *See* Letter from the Honorable William H. Donaldson, Chairman, Commission, to Meyer S. Frucher, Chairman, Phlx, dated May 29, 2003.

Additionally, the Phlx has assessed the proposed rules in the Amended Proposal concerning the operation of the BOX in relation to the Plan for the Purpose of Creating and Operating an Intermarket Options Linkage (the “Linkage Plan”)’ and, if approved, such rules would not be compliant with the Linkage Plan.

### **Internalization in the Price Improvement Period**

The Original Release included a description of a three-second Price Improvement Period (“PIP”), in which an OFP could submit its own proprietary Primary Improvement Order **as** contra-side to a customer order it represents. The Primary Improvement Order must be for a better price than the NBBO by at least one penny (not a standard option pricing increment), which commences the three-second “PIP,” during which BOX participants may bid or offer in pennies to compete with the Primary Improvement Order. Bids and offers submitted by BOX participants during the PIP would not be disseminated; thus, only BOX participants would know the nature of such bids and offers, and customers could not, under the Original Release, participate in the PIP.

The Phlx and others commented that the three-second PIP was not a sufficient amount of time for market participants to assess the risks associated with a particular trade and/or position and determine to bid or offer during the PIP, and thus the PIP functions not as an “auction” but as a platform for OFPs to internalize order flow while minimizing the possibility that another market participant would actually match or improve on their Primary Improvement Order. The PIP thus functions to favor highly capitalized internalizing firms with advanced (and faster) technology over smaller, less capitalized market participants by enabling them to effect a “race to the market” to ensure 100% participation in internalized orders.

The Amended Proposal provides that, in order for a PIP to be initiated, at least three BOX Market Makers must be quoting in the particular series that is subject to the PIP. The three Market Maker quoting requirement does not in any way address the “race to the market” that would result from the three-second PIP. A highly capitalized OFP could potentially initiate a PIP and effectively shut out lesser-capitalized Market Makers, regardless of the number of Market Makers quoting in the series.

The Amended Proposal also includes a new order type, the Customer PIP Order (“CPO”), which is a limit order that can be placed on the BOX book with a designation that, if such CPO represents the NBBO and a **PIP** is initiated, the customer limit order will be treated as a BOX market maker order during the PIP. The CPO would be submitted to the BOX in regular trading increments (*i.e.*, .05 or .10) and designated by the customer with a fixed number of pennies by which it would improve the market during the PIP. The customer is dependent on the BOX participant that represents their order, and on the BOX participant’s technology, for purposes of participation in the PIP.

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<sup>9</sup> See Securities Exchange Act Release Nos. 44482 (June 27, 2001), 66 FR 35470 (July 5, 2001) (Amendment to Plan to Conform to the Requirements of Securities Exchange Act Rule 11Ac1-7 (the “Amendment”)); 43573 (November 16, 2000), 65 FR 70851 (November 28, 2000) (Notice of Phlx Joining the Plan); and 43086 (July 28, 2000), 65 FR 48023 (August 4, 2000) (Approval of the Plan).

When subject to the “auction” in the PIP, the CPO, like other orders and quotes in the PIP, would not be disseminated by BOX. The CPO and other orders subject to the PIP thus amount to a “shadow” or hidden market, inconsistent with Congress’ stated goal of a National Market System to assure the availability of brokers, dealers, and investors of information with respect to quotations for and transactions in securities.” These orders do not receive the value-added benefits of exposure to other competing market centers. Moreover, whether or not customer limit orders are eligible for participation in the PIP, the PIP would still last for only three seconds. Merely adding the CPO order type to the PIP does not address the main concern raised by the Phlx and other commentators: that the BOX is designed to function as a internalization engine that favors highly capitalized OFPs that wish to participate as the contra-side to their own customers’ orders (when it appears that doing so would be advantageous) without incurring any of the risks and responsibilities that liquidity providers (such as, for example, Phlx specialists and Registered Options Traders) are required to assume.

### **New Opportunities for OFPs to Internalize Outside of the PIP**

The Amended Proposal also includes *two new alternatives to the PIP for OFPs to internalize orders*. OFPs would now have the ability to execute their own customer orders in one of two ways: (1) by exposing the customer order to the market for thirty seconds prior to sending their own proprietary contra-side order for execution; or (2) if the OFP has been bidding or offering on BOX for at least thirty seconds “prior to receiving” a customer order that is executable against such a bid or offer, such a customer order would be immediately executable against the OFP’s established bid or offer.

With respect to the second alternative, there is a high likelihood that an OFP could simply hold back a customer order during the time its own bid or offer is exposed (after establishing priority over other BOX bids and offers), and then simply send the customer order to BOX for immediate execution (and thus 100% internalization of the order) after 30 seconds, with no prior exposure of the customer order. The Amended Proposal does not offer any explanation of how BOXR would surveil for OFPs holding the customer order without action for 30 seconds in this practice. It is critical to fair competition that such opportunities be properly surveilled across all exchanges and that appropriate systems and procedures be in place before the Commission could possibly approve the Amended Proposal.

### **“BOX-Top” Orders**

There would be no traditional market orders on BOX, but instead, “BOX-Top” orders, which would be executed at the best available price up to the total quantity available on the BOX bid or offer. Remaining contracts would be booked as limit orders. Thus, there would be no automatic split-price executions on BOX, and traditional market orders would not be accepted.

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<sup>10</sup> 15 U.S.C. 78k-1(a)(1)(C)(iii).

The BOX-Top order type would almost certainly result in a high number of locked or crossed markets in the options markets respecting the unexecuted remaining portion of such orders after the marketable portion is executed at the NBBO. For example, assume BOX is offering 500 contracts at the NBBO of 2.10, and another exchange is also offering contracts at 2.10. If an order to buy 1,000 contracts is sent to BOX as a BOX-Top Order, 500 contracts would execute on BOX at 2.10, and the remaining 500 contracts would be booked on BOX as a bid for 500 contracts at 2.10. The bid for 500 contracts at 2.10 would lock the other exchange's offer at 2.10.

Many exchanges, including the Phlx, disengage automatic execution systems during times of locked or crossed markets.<sup>11</sup> One main purpose of the disengagement of automatic execution systems during times of locked or crossed markets is to avoid an instant execution at a price that could turn out to be inferior to the NBBO, absent any inquiry as to the actual NBBO. The Box-Top order type would thus affect competing exchanges' systems and would result in fewer automatic executions on all markets. This disruption in the markets as a whole would be completely at odds with the goal of a National Market System to assure fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets.<sup>12</sup> Moreover, during a time when some market participants have been alleging that locked and crossed markets are an issue in the equity markets, particularly respecting Nasdaq markets, it seems particularly inappropriate to entrench and encourage the practice in the options markets.

Additionally, this order type is at a minimum inconsistent with the Linkage Plan, which provides that market participants should not lock or cross markets, and if they do, the participant that locks or crosses the market is required to unlock or uncross the market. If BOX simply places the remaining contracts in the BOX-Top Order on the BOX limit order book, they would not be fulfilling this obligation.

### **Interaction of BOX Orders With Linkage Plan Participants**

The Amended Proposal includes a description of the manner in which BOX participants would interact with participants in the Linkage Plan. The Linkage Plan includes a provision that a "Linkage Order" is, among other things, an Immediate or Cancel Order (defined as a limit order that is to be executed in whole or in part as soon as such order is received, and the portion not executed, if any, is immediately canceled). Linkage Plan participants may send Linkage Orders through the Linkage only if such orders are priced at the National Best Bid/Offer ("NBBO").

The Amended Proposal provides that, if BOX receives a Principal as Agent ("P/A") Order from an away market but is no longer quoting at the NBBO at the time of receipt such that the execution of the P/A order would cause a trade-through, BOX will

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<sup>11</sup> See, e.g., Phlx Rule 1080(c)(iv)(A).

<sup>12</sup> 15 U.S.C 78k-1(a)(1)(C)(ii).

expose the P/A Order to BOX participants for three seconds at the NBBO. If the P/A Order is not fully executed at the end of this period, the residual quantity is cancelled back to the originating exchange. The proposed three-second exposure period is completely inconsistent with the requirement in the Linkage Plan that Linkage Orders must be Immediate or Cancel Orders, and thus would again result in a violation of the Linkage Plan.

Furthermore, Section 7(a)(ii)(A) of the Linkage Plan requires that the receiving Participant must execute the P/A Order in its automatic execution system, if available, if its disseminated quotation is equal to or better than the NBBO when that order arrives at the receiving Participant. That Participant then must immediately report the trade to the Option Price Reporting Authority (“OPRA”) for dissemination under the OPRA Plan with the identifier assigned to the receiving Participant. The BOX is proposed as a purely electronic exchange; all trades would be executed in its automatic execution system. The three-second exposure period would preclude BOX from fulfilling the requirement to execute the order in its automatic execution system and immediately report the trade to OPRA. Thus, the Amended Proposal is not consistent with, and if approved would result in violation of, the Linkage Plan.

\* \* \* \*

For the foregoing reasons, the Phlx believes that the Amended Proposal: (1) does not contain sufficient responses to the Phlx Comment Letter and other commentators to justify a finding that the proposal is consistent with the Exchange Act, and (2) does not satisfy the standards set forth in Sections 6(b)(5),<sup>13</sup> 6(b)(8),<sup>14</sup> and 11A<sup>15</sup> of the Exchange Act, because it imposes an inappropriate burden on competition, permits unfair discrimination between brokers and dealers, and is at odds with the fundamental goals of a National Market System. Accordingly, the Phlx believes that the Amended Proposal is statutorily deficient and should not be approved.

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<sup>13</sup> 15 U.S.C. 78f(b)(5).

<sup>14</sup> 15 U.S.C. 78f(b)(8).

<sup>15</sup> 15 U.S.C. 78k-1.

We appreciate the Commission's consideration of our comments. If the Commission or its Staff should have any questions regarding the matters discussed above, please contact Lanny A. Schwartz, Executive Vice President and General Counsel at (215) 496-5406.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Meyer S. Frucher". The signature is fluid and cursive, with a long horizontal stroke at the end.

Meyer S. Frucher  
Chairman and Chief Executive Officer

cc: The Honorable William H. Donaldson, Chairman  
The Honorable Paul S. Atkins, Commissioner  
The Honorable Roel C. Campos, Commissioner  
The Honorable Cynthia A. Glassman, Commissioner  
The Honorable Harvey J. Goldschmid, Commissioner  
Annette Nazareth, Director, Division of Market Regulation  
Robert Colby, Deputy Director, Division of Market Regulation  
Elizabeth King, Associate Director, Division of Market Regulation