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December 16, 2003

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 **Fifth** Street, N.W.
Washington, D.C. 20549



Re: File No. SR-BSE-2002-15, Amendment No. 3; Release No. 34-48355

Dear Mr. Katz:

The International Securities Exchange, Inc. ("ISE") submits this supplemental comment letter on Amendment No. 3 (the "Amendment") to the Boston Stock Exchange's ("BSE") proposed Boston Options Exchange ("BOX") rules package. We have commented on the original proposal, arguing that the filing was not consistent with the requirements of the Securities Exchange Act of 1934, as amended (the "Exchange Act").¹ Among other problems, we viewed BOX as a vehicle for the internalization of customer order flow, rife with conflicts of interest, and operating in a manner inconsistent with a broker-dealer's best execution obligations. We further commented on the Amendment, explaining how that Amendment actually exacerbated the problems in the original filing.¹ This letter addresses only one issue: our belief that the Commission should not approve the currently-proposed internalization and preferencing features of BOX prior to the Commission's pending in-depth consideration of these issues.

The most troubling aspects of BOX are the proposed "Price Improvement Period" ("PIP") and "Directed Orders." The PIP will allow BOX participants to internalize small customer orders with little opportunity for those orders to interact with other trading interest. Our Letters provide a detailed analysis of our concerns with this proposal and explain how the PIP would result in internalization on a much greater scale than the Commission has ever sanctioned in the listed options market.

The BSE first introduced the concept of the Directed Order in the Amendment. A Directed Order would permit a BOX participant to send an order to a specified BOX market maker, who could then use the PIP as an internalization vehicle to trade against the order. Our September Letter explained our concerns with this aspect of BOX, focusing on how this would lessen quotation competition and foster payment-for-order-

¹ Letter dated February 12, 2003 from Michael J. Simon, Secretary, ISE, to Jonathan G. Katz, Secretary, Commission (our "February Letter").

² Letter dated September 12, 2003 from Michael J. Simon, Secretary, ISE, to Jonathan G. Katz, Secretary, Commission (our "September Letter," and together with the February Letter, our "Letters.")

flow ("PFOF"). The Directed Order concept is revolutionary in the options markets: the Commission has never permitted an exchange to offer a "preferencing" system that allows market makers to capture order flow completely outside of quotation competition.

At the same time that the BSE is asking the Commission to consider radical changes to rules governing internalization, preferencing and PFOF in the options market, we understand that next month the Commission staff will be presenting the Commission with a proposed concept release ("Concept Release") on these very issues. We support the Commission's issuance of a release seeking public comment on these matters. Moreover, we believe that the Commission should act very cautiously before approving radical changes to the current options market structure. In this regard, the listed options market is one of the most vibrant securities markets in the world. The five current exchanges compete vigorously for market share through price and service competition. Impending entrants like BOX provide further incentives for markets to be competitive. This competition directly benefits investors by offering them better prices and more efficient trading opportunities.

One outgrowth of exchange competition has been a rise of the questionable practices of internalization and PFOF. As we explain in detail in our Letters, and as we have explained in person to the staff and to the Commissioners, limited forms of internalization benefit customers by adding liquidity to the market. However, the unprecedented level of internalization that **BSE** proposes – compounded by the preferencing and PFOF ramifications of the Directed Order – clearly would upset the current delicate balance of competitive interests in the market and ultimately would harm investors. We strongly believe that the Commission should issue its Concept Release and consider all comments it receives before considering the PIP and Directed Order proposals in their current format.

We do appreciate that the BSE and its partners have spent considerable time and money in the construction of BOX and that they see some urgency in the Commission's consideration of its application. However, that urgency should not obscure the fact that they are proposing radical changes to the options markets in areas that the Commission itself recognizes that it has not yet fully explored. We thus recommend that the Commission consider the BOX proposal without PIP and Directed Orders at the current time. The BSE, as well as the other exchanges, always would be able to submit revised internalization, preferencing and PFOF proposals for Commission consideration if the Commission changes its policies in these areas following the issuance of its Concept Release and the consideration of the comment letters.

For the Commission to rule on the PIP and Directed Orders prior to conducting this review necessarily will require the Commission to make important policy decisions based on less than full information. Moreover, once PIP and Directed Orders are operational in the market, competitive pressure will force other exchanges to match this functionality. Events soon will overtake the careful deliberations that the Commission now contemplates. Even if the Commission ultimately were to conclude that PIP and Directed Orders – and their progeny – raise serious concerns and harm investors, it will be impractical, if not impossible, to turn these systems off once they become entrenched in the market place. By that time, the current vigorous and healthy competition in the options markets may well have been severely compromised.

We believe that initially considering BOX without PIP and Directed Orders is a reasonable approach that is fair to the BSE, the other exchanges, and most importantly, the investing public. As to the BSE, they could begin operations operating under the

current regulatory policies that govern all the other exchanges. They also would be able to offer those unique aspects of the **BOX** proposal that do not touch internalization or **PFOF**.³ They also could offer internalization and PFOF programs consistent with those the Commission has approved for every other options exchanges. This approach also would be fair to the current five exchanges, who would have an **opportunity** to work with the Commission to develop policies on internalization and PFOF that are fair and uniform across markets. Finally, this would benefit investors since they will be the ultimate beneficiaries of the policies that the Commission develops in this area after carefully consider all competing interests.

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We continue to believe that the **BOX** proposal raises serious issues under the Exchange Act. As the Commission considers the proposal, we again ask that the Commission carefully consider the comments we made in our Letters. Furthermore, if the Commission is to act on the **BSE's** filing in the near future, we specifically request that you not approve any internalization, preferencing or PFOF aspects of **BOX** that materially differ from the similar functions that the Commission has approved to date in the options market. Rather, we urge the Commission first to issue the Concept Release and then to review the responses to that release before establishing any new policy positions regarding options internalization, preferencing of PFOF. If you have any questions on our comments, please do not hesitate to give us a call.

Sincerely,



Michael J. Simon
Senior Vice President and Secretary

cc: Chairman Donaldson
Commissioner Atkins
Commissioner Campos
Commissioner Glassman
Commissioner Goldschmid

Annette Nazareth
Robert Colby
Elizabeth King
Stephen Williams

³ In making this proposal, we reiterate that our Letters raised a number of concerns with **BOX** outside of the areas of the PIP and Directed Orders. We are confident that the Commission will give those comments due consideration and would not approve the **BOX** proposal unless the **BSE** amends its filing to bring the proposal into compliance with the requirements of the Exchange Act.