



November 10, 2005

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: File No. SR-CBOE-2005-60, Amendment No. 1

Dear Mr. Katz:

The Boston Stock Exchange (“BSE”) and its wholly-owned subsidiary, Boston Options Exchange Regulation (“BOXR”), appreciate the opportunity to comment on the Chicago Board Options Exchange’s (“CBOE”) proposal to implement an Automated Improvement Mechanism (“AIM”). The rule proposal addresses a price improvement mechanism (i.e. AIM) similar to the Price Improvement Period (“PIP”) of the Boston Options Exchange (“BOX”).

In reviewing the proposed rule filing it seems clear that there are numerous ambiguities relating to the operation and structure of AIM that are not directly addressed by the CBOE proposed rules. Because of these ambiguities it is difficult in some instances to discern the intent of certain aspects of the proposed rules. In addition, we believe that it would be difficult for market participants to understand and effectively utilize the mechanism while competing to provide price improvement as the rules are currently drafted in the proposal. We also believe there are several elements of the rule filing that appear to conflict with previous guidance provided by the staff of the Securities and Exchange Commission (“Staff”) regarding similar price improvement mechanisms (*i.e.*, the PIP and the Price Improvement Mechanism (“PIM”) of the International Securities Exchange). As a result of these ambiguities, customer orders that participate in the AIM could be exposed to undue harm while perhaps other participants within AIM might be unfairly advantaged. If the proposal, as currently drafted, is approved, the CBOE AIM proposal would actually serve to reduce liquidity on the CBOE and diminish the likelihood of price improvement.

This letter discusses some of the more problematic elements of the rule proposal, including lack of clarity and specificity with respect to pivotal elements of the AIM, possible market integrity and investor protection concerns, and possible inconsistency with prior Staff guidance. This letter does not necessarily address all possible ambiguities or deficiencies with respect to the rule proposal.

The following areas will be addressed in this comment letter:

1. AIM Auto-Match¹ feature;
2. Treatment of non-marketable opposite side unrelated orders;
3. Lack of any initial price improvement increment for certain orders in an AIM Auction;
4. Definition of the “matching algorithm”;
5. Ability and process of the Initiating Member to “solicit” the contra side of an AIM Agency Order; and
6. Floor broker submission a RFR responses on behalf of orders at the top of the book.

The following is a more comprehensive discussion of these shortcomings.

1. THE AUTO-MATCH FEATURE -- UNFAIR COMPETITIVE ADVANTAGES

The AIM rule proposal allows an Initiating Member within an AIM Auction to specify either a single price at which to cross the Agency Order or to indicate that it is willing to automatically match, as principal, the price and size of all Auction responses (*i.e.*, Auto-Match).

The operation of the Auto-Match feature coupled with other components of the AIM system, in particular the random end-time of the AIM (3-5 seconds) and the blind nature of the auction (*i.e.*, the size and price of RFR responses are not visible), provide a significant technological and economic advantage to the Initiating Member. It appears from the rule proposal, that the AIM broadcast does not provide information to Members about the best-priced RFR responses (see proposed CBOE Rule 6.74A(b)(1)(F)). As a result, Members simply do not have enough information to make a fully-informed decision about how to compete for the Agency Order. Members should be provided with information about all of the competing orders that could potentially receive some of the AIM allocation. For example, if a Member that was quoting the second best price was informed of the details of other competing orders (*i.e.*, size and price), the Member would be better equipped to calculate the amount of its allocation at that price and ultimately decide whether to improve its price or increase its size. If a Member knew that RFR responses had improved the price, the Member could compete against these better prices. Not having all of this information available limits the opportunity for the Agency Order to receive the best price possible.

The Auto-Match feature is offered exclusively to the Initiating Member. It is unclear why those firms submitting RFR responses are not permitted to participate in the Auto-Match feature. Exclusivity, with respect to participating in the Auto-Match feature, may result in preferential treatment of the Initiating Member. More specifically, because the AIM system is controlling the Auto-Match response, it is likely to assure the Initiating Member the fastest response time to any competing RFR responses and thereby provide Initiating Members with a technological advantage. Additionally, the Auto-Match feature appears to provide the Initiating Member with an automatic “last look” at the best priced RFR response, thereby guaranteeing the Initiating Member his allocation in any Auction. For all of these reasons, we believe the Auto-Match feature as proposed does not protect customer interests.

¹ Terms defined within this comment letter shall have the same meaning as provided for in this rule filing and the relevant CBOE rules, unless otherwise provided.

2. THE TREATMENT OF OPPOSITE SIDE UNRELATED ORDERS -- LACK OF CONSISTENT TREATMENT AND PRONE TO MANIPULATION

In discussing the termination events of an AIM Auction, CBOE indicates in the rule proposal that, among other things, an AIM Auction will be terminated upon receipt of an unrelated, *non-marketable* limit order (in the same series as the Agency Order on the opposite side of the market) and that improves any RFR response. It is unclear why this type of order should terminate the AIM Auction, unless it is for the full size of the Agency Order. Other price improvement systems, such as the PIP and the PIM, treat such orders as price improvement orders. Including such orders within the AIM Auction would increase the number of RFR responses and, therefore, maximize the potential for price improvement by continuing the Auction.

In addition, this feature gives a person participating in an AIM Auction another avenue to prematurely terminate the Auction for purposes of manipulating the market. For example, a person could submit a one-contract, non-marketable, opposite side limit order with the intent of prematurely terminating the Auction so as to secure the execution of their order within the Auction. This is contrary to the basic tenet of the federal securities laws which purport to mitigate the likelihood of such manipulative conduct (*see, e.g.*, Sections 9 and 10 of the Securities Exchange Act of 1934 (“Exchange Act”).

3. THE LACK OF ANY INITIAL PRICE IMPROVEMENT INCREMENT FOR CERTAIN ORDERS IN AN AIM AUCTION -- FACILITATION VERSUS PRICE IMPROVEMENT

Improvement systems such as AIM, among other things, are intended to provide the market with increased opportunities for price improvement. It appears to be inconsistent with this underlying purpose for AIM not to require a minimum initial price improvement increment over the National Best Bid or Offer (“NBBO”) for certain types of orders (i.e., orders over fifty contracts). Without an initial minimum price improvement increment it is possible that an AIM auction will not result in price improvement at all, but, rather, will function merely as a facilitation mechanism at the NBBO. If the intent is to create a facilitation mechanism as well, then the proposed rules should clearly define such a mechanism and not shroud it under the guise of a price improvement mechanism rule. Other price improvement systems, such as the PIP and the PIM, initiate an auction for such orders with a required price improvement of at least one-cent better than the NBBO. Approving AIM as proposed would appear to conflict with previous guidance provided by the Staff that required price improvement of at least one-cent better than the NBBO. This feature was required by the Staff with respect to the PIP and the PIM.

AIM’s intended facilitation of orders, especially those between 50 and 250 contracts, is largely unnecessary in the current options market place. A survey of the quote sizes that are consistently posted by the options exchanges demonstrates that there is more than adequate liquidity available at the NBBO. For example, the majority of BOX market makers post bids and offers of 20 contracts or more and there are several market makers for each class. Also, the quote sizes are vastly more in the case of the most active classes and series such as QQQQ (500-1,000) and MSFT (200-500). For this reason, the quantity available on the NBBO at a given exchange is very often significantly greater than 50 contracts. Further, it is not clear why a facilitation mechanism would allow the facilitator to ever step in front of previously booked orders and quotes at an exchange, regardless of account type. Allowing facilitation in an automated mechanism at the NBBO only furthers the dilution of liquidity providers’ economic interest in posting quality markets, since they can be pre-empted.

4. DEFINITION OF THE MATCHING ALGORITHM -- NEED TO DEFINE

The order allocation section of the proposed rule (CBOE Rule 6.74A(b)(3)) indicates that orders will be allocated according to an undefined “matching algorithm” in effect for the class subject to certain

conditions. Although the rule identifies the exceptions to the matching algorithm, it fails to provide any other information. In addition, the proposed rule appears to indicate that this undefined matching algorithm is defined differently for different classes of options. Clearly, the “matching algorithm” is the nerve center of the AIM Auction and, therefore, must be fully and completely defined and discussed within the rule proposal. The lack of any disclosure with regards to the inner-workings of AIM and its “matching algorithm” will not permit the Securities and Exchange Commission and its Staff to meet its statutory obligation to ensure that the rules of a Self-Regulatory Organization comply with relevant requirements of the Exchange Act. It also does not permit any meaningful comment by the public.

5. ABILITY AND PROCESS OF SOLICITING POTENTIAL RFRS -- LACK OF CLARITY

The rule proposal provides for the ability of an Initiating Member to “solicit” the other side of an AIM Agency Order instead of providing its own principal order but fails to define the solicitation process. The lack of any discussion on this important facet of the AIM Auction would seem to hinder the Staff’s ability to fully comprehend the mechanics of the AIM system. Additionally, without a defined process, customer orders are not afforded the necessary protections from potential abuse. For example, an Initiating Member may attempt to side-step the anonymity feature of the Auction or breach certain information barriers that exist between an Initiating Member and another person participating in the AIM Auction in order to engage in manipulative conduct. Procedural protections are necessary to ensure that customer orders are adequately shielded from this type of activity and should adequately describe:

- who may be solicited;
- how the solicitation process works;
- if and how the Initiating Member manages the bidding for the solicited counterparty while the AIM Auction takes place; and
- any procedural mechanism to protect customer orders from being unfairly disadvantaged by the ability of market makers to decline participation in an AIM Auction (e.g., lack of any “guaranteed directed order” process as provided under the BOX and ISE rules).

As currently drafted, the AIM rules do not address these areas. The Commission required BOX to codify similar procedural protections with respect to its version of a solicitation mechanism (*i.e.*, the Directed Order process) and, therefore, it would be anti-competitive and contrary to investor protection concerns to not require the CBOE to implement similar procedural protections.

As previously mentioned, the rule proposal does not prevent market makers or the Initiating Member from misusing customer information which may be derived from the Agency Order or the solicited orders. A possible explanation for this might be that market makers in the class are simply not allowed to initiate the AIM process and therefore will not have access to such information. This, however, raises serious concerns about whether AIM is really designed to provide actual price improvement or is simply an order flow provider internalization scheme. The BOX Directed Order rules allow any firm to solicit a willing market maker for price improvement, regardless of whether or not they have an established relationship. If the intent behind the rule proposal is to preclude the solicitation of a market maker for the initial price improvement then it would seem that the AIM is a pure internalization mechanism that is available to only a few firms. The rule proposal must clarify, among other things, the parameters for a market maker and initiating member’s to access customer information which may be derived from solicited orders and agency orders.

In addition, it is our understanding that it is generally the industry practice for brokers to limit their solicitation of orders to fill large customer orders (*i.e.*, over 300 contracts or more). Given this

industry standard, it is unclear to the BSE what purpose is served by allowing solicitation for all contract sizes -- in particular agency orders under 50 contracts. We believe the rule proposal should clarify this deviation from standard industry practice.

6. ABILITY OF FLOOR BROKERS TO SUBMIT RFRS -- FEASIBILITY

Under the rule proposal, a Floor Broker is permitted to “submit responses to an RFR”. It is unclear how this would occur in light of the limitations generally imposed on Floor Brokers and the speed of the AIM Auction period. In general, Floor Brokers do not have access to the type of automated systems that would permit them to participate in an AIM Auction that spans three to five seconds. We believe that it is more sensible to have the CBOE order book interact **automatically** with the AIM Auction to ensure that those orders are properly represented in the AIM. Indeed, this is implied in the rule text that assigns priority to any public customer orders already on the CBOE book in the case where an auction is terminating at that price. If this is already automated, what is the need for this rule clause?

If, however, the intention of this rule is to allow customers to submit RFR responses in an Auction, why is there no description of this new order type in CBOE’s rule proposal? How does the Floor Broker know a customer wishes to submit an RFR response? How does he know what the RFR response price limit would be in such a case? The BOX Rules regarding Customer PIP Orders (“CPO”) are very detailed on this subject, CBOE should be held to the same standard to protect customer interests. Furthermore, it would seem that the ability of the Initiating Member to select the Auto-match function in AIM would give him an unfair advantage over customer orders which did manage to submit an RFR response which raises customer priority concerns.

CONCLUSION

Due to the issues discussed in this comment letter, as well as any other comments which we and others may provide at a later date, the BSE urges the Commission not to approve the proposal in its current form. In light of the absence of basic details regarding the AIM Auction and its related processes, it is virtually impossible for the Securities and Exchange Commission and its Staff, as well as commenters, to adequately understand and assess the functionality of the AIM Auction and its overall compliance with the requirements of the Exchange Act.

If there are any questions or comments regarding the issue raised herein, please do not hesitate to contact me.

Sincerely,

Annah Y. Kim

Annah Y. Kim
Chief Regulatory Officer
Boston Options Exchange Regulation.

cc: Kenneth Leibler