



BOSTON
STOCK EXCHANGE

March 24, 2004

Kenneth R. Leibler
Chairman and
Chief Executive Officer

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

Re: File No. SR-ISE-2003-06
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 International Securities Exchange's ("ISE") proposal to implement a Price Improvement Mechanism ("PIM"). Although ISE recognizes, as stated in Item 8 of their filing, that the proposed rule change is similar in some aspects to the Boston Options Exchange ("BOX") PIP, the ISE fails to point out that the ISE market does not have many of the pro-competitive elements of the BOX market structure which encourages overall quote competition and result in the return of the inherent value of order flow to the customer, rather than to trading firms with specialist franchise trading rights.

While imitation is the sincerest form of flattery, ISE's proposal falls far short of a true imitation with a scheme that will hurt customers, and the marketplace in general. The potential for customer harm exists in every aspect of the PIM process in which customers can participate – as a customer whose Agency Order may be submitted to the PIM, as a customer whose order may be solicited as the initial counterside order to the Agency Order (the "Counter-Side Order" or the "CSO"), and as a customer who wishes to compete for the Agency Order. As required by the Securities and Exchange Commission (the "Commission"), BOX's rules establish a high standard of customer protection. If ISE's proposal is approved as currently proposed, BOX will have to consider amending its rules to be able to fairly compete with ISE's lower standards.

If approved, the ISE PIM proposal would actually serve to reduce liquidity on the ISE and diminish the likelihood of price improvement. In addition, the proposal violates Commission requirements regarding allocation and would, as proposed, result in the

Commission requirements regarding allocation and would, as proposed, result in the occurrence of trade-throughs of the National Best Bid or Offer (“NBBO”). For these and other reasons explored more fully below, the proposal is not consistent with the requirements of the Securities Exchange Act of 1934 (the “Act”), and we urge the Commission to institute proceedings to determine whether the proposal should be disapproved. Aside from the multitude of unanswered questions in the ISE’s proposal, many of the elements of the proposed PIM that have been described are unacceptable and inconsistent with Commission requirements and the provisions of the Act. These include:

40% allocation

The ISE’s proposed PIM allocation is calculated very differently than the BOX PIP and will give much greater than a 40% guarantee to the EAM in many cases, even when there are others at the same price as the EAM initiating the proposed PIM.

Facilitation

ISE’s proposed PIM cannot coexist with the ISE Facilitation Mechanism rules, as it will allow for the gaming of facilitation orders.

Trade-Throughs

Under ISE’s proposal, trade-throughs will result from the execution of unrelated orders during the PIM. BOX has a programmed “NBBO Filter” which prevents this occurrence. The ISE lacks this fundamental functionality.

Price Competition

The ISE PIM proposal includes pro rata trade allocation based on size. This does nothing to foster price competition.

Price Improvement

The information described to be broadcast prior to and during the proposed PIM is insufficient to encourage competitive bidding.

The most important competitive elements missing from the ISE’s PIM proposal are:

- There is no time priority in the ISE book, or in the proposed PIM. Therefore, on ISE there is no incentive for a market maker to be the first to post the best quote or improve the PIM price.
- There is no Market Maker Prime, as there is on BOX, so there is no mechanism to encourage the aggressive improvement of the quote in the regular market outside the PIM.¹

¹ In the BOX approval order 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 [Market Maker Prime], is consistent with the Act and may provide a further incentive for Market Makers to publicly display their best

- There are too many special allocation privileges already in place on the ISE market, such as the PMM Small Order Allocation guarantee, that, if combined with the proposed PIM, will serve to further degrade the ISE market and discourage participation and true competition.

Through this proposal and others of late (See, e.g. SR-ISE-2003-07, regarding ISE's Facilitation Mechanism), the ISE has shown its desire to forego meaningful customer protections and price improvement in favor of the firms seeking to facilitate orders. Since the present filing is extremely cursory, and leaves many essential questions unanswered, we are unable to comment fully on all of the ways in which ISE's proposal favors ISE Members over public customers. For instance, the ISE proposes that an EAM would be able to solicit other Members to act as a counterparty to the Agency Order and then initiate a PIM. But the filing does not describe who can be solicited, the time parameters as to when they can be solicited, or even how the solicitation is to be accomplished. Additionally, it is unclear, because it is simply unstated, as to what happens to the Agency Order and the solicited CSO orders during the solicitation process. Does the EAM hold the Agency Order? If so, what procedural protections are in place to insure that there is no misuse of the customer Agency Order? How is this process consistent with the EAM's best execution obligations? When compared to BOX's very descriptive rules, particularly those related to the Directed Order process, the ISE proposal falls short and leaves far too many unanswered questions. Also, ISE's proposed rules lack basic procedural protections, which, as addressed herein, are set forth in detail in the BOX Rules. Other basic questions regarding the proposed solicitation process abound, including:

- What is the process by which the EAM can solicit multiple counterparties for the CSO?
- How are the multiple counterparties' orders/instructions managed if they are of differing sizes and/or prices?
- Is there an allocation if multiple counterparties for the CSO are involved? If so, how is it accomplished and by whom?

Further essential questions regarding the PIM exist that the BSE believes must be addressed. These issues were required to be described in detail in the BOX Rules and are simply non-existent in the ISE's PIM proposal. For instance,

- How will the PIM interact with the InterMarket Linkage? The BOX PIP rules comply with the provisions of the InterMarket Linkage Plan, while the

quotes, which would benefit all options market participants." See, Securities Exchange Act Release No. 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004) at 2790.

proposed ISE PIM rules lack explanation as to how they will comply with the provisions of the InterMarket Linkage Plan.

- Since customer Improvement Orders seem to be permitted, who can introduce these orders? How are they allocated executions at the end of the PIM? If they are not permitted, why not? The BOX rule filings and the BOX Rules contain an in-depth discussion of customer orders and how they can participate in the PIP.²
- What information will be included in the PIM broadcast? It is critical to know this information in order to ascertain whether ISE Members will be able to intelligently compete in the proposed PIM. The BOX Rules contain a detailed description of what is included in the PIP broadcast.³

The following is a more in-depth discussion of the shortcomings of the ISE proposal, which make it unacceptable for approval by the Commission.

I. ISE'S MARKET STRUCTURE ALREADY PROVIDES TOO MANY SPECIAL ALLOCATION PRIVILEGES TO PERMIT THE ADDITION OF THE PROPOSED PIM

In formulating the BOX Market, the BSE worked closely with the Commission's Division of Market Regulation Staff ("Staff") to strike a balance between the opportunity to interact with the order flow that a Participant brings to BOX and other market structure mechanisms designed to improve the quality of the public marketplace. In particular, the BOX market has:

- An open market structure, open to all types of market participants;
- No specialists or specialist entitlements;
- Low trading costs;
- Low barriers to entry;
- Price/time priority to encourage aggressive quoting; and

^{2/} See Securities Exchange Act Release No. 48355 (August 15, 2003), 68 FR 50813 (August 22, 2003). See BOX Rules Chapter V, Section 18(g).

³ See BOX Rules Chapter V, Section 18(e).

- A Market Maker Prime rule which creates an incentive to quote aggressively in the BOX Book.⁴

The ISE now seeks to essentially copy the BOX PIP with a proposal that is sorely lacking in the various accompanying market structure rules and measures which lead to enhanced competition and transparency, offer customer protections, and lead to true price improvements. Contrasted to the BOX Market, the ISE instead has:

- Special allocation entitlements in its basic market to PMMs (i.e. small order preferencing), which act to discourage PMM affiliates from submitting Agency Orders to the PIM and PMM participation in the proposed PIM, rather than encourage participation and thereby price improvement;
- Limited market maker franchises and costly Memberships;
- No time priority; and
- No Market Maker Prime rule, and therefore no incentive to improve, rather than match, the NBBO in the “regular” market.

The ISE proposal does nothing to encourage price improvement of small orders, which typically represent individual investors. The PMM allocation preferences afforded by ISE, combined with the opportunity for PMMs to act as the CSO in the proposed PIM, gives PMMs too many allocation advantages and will serve to discourage market participation. There is also the situation that because PMMs can retain small orders and price them at the NBBO, affiliates of the PMMs would continue to send their orders to the regular ISE market rather than risk losing the orders by submitting them to the proposed PIM process and have them priced at least one penny better than the NBBO. In addition, PMMs would have less incentive to participate as the solicited CSO because unsuccessful solicitations would result in the customer order being sent into the regular market, where there are higher allocations for the PMM. Therefore, for small orders the use of the PIM as well as competition in the PIM is discouraged.

The ISE also has Facilitation Mechanism rules which, when combined with the proposed PIM, actually discourages PIM participation. With the Facilitation Mechanism, an ISE Member can interact with its own order flow, but is free to cancel the order at any time. Through this Facilitation Mechanism, an EAM on ISE can attempt to facilitate an order (at a price which can actually be inferior to the NBBO!), which is not broadcast. Since a facilitation order can only be improved with a “regular” order, as opposed to another facilitation order, and the regular order is displayed, it is easy for the EAM to calculate the ultimate price of the facilitation execution, and whether or not the EAM will be able

⁴ See BOX Rules Chapter V, Section 19.

to retain the order.⁵ If the EAM will not be able to retain enough of the order through the Facilitation Mechanism, then the EAM can simply cancel the order, and submit it to the proposed PIM process, thereby guaranteeing himself at least 40% of the ultimate allocation of the order. Alternatively, the EAM can solicit orders for the CSO. Using the information from the solicitation process, the EAM can then decide which facilitation process to utilize. The BSE believes that allowing both facilitation processes exposes customers unnecessarily to market risk while the EAM waits to see which process will benefit itself and ultimately disadvantages customers.

Contrasted to BOX, the ISE proposal does nothing to encourage participation in the proposed PIM, and sorely lacks basic customer protections, such as those set forth in the BOX Directed Order rules, which prevent Options Participants from shopping within their own market for the price which is most advantageous to the Options Participant, as opposed to the customer.

II. PIM WILL DISCOURAGE PRICE COMPETITION AND AGGRESSIVE BIDDING

A. Lack of Time Priority Will Discourage Price Competition in the PIM Auction

There are three types of Members that will respond to the PIM: those that wish to participate only at the current price, those that are willing to improve the price to get a certain allocation, and those that are just willing to improve the price.

Pursuant to proposed ISE Rule 723(d)(3), the applicable portion of the Agency Order will be allocated among ISE Members based not upon time priority, but upon the percentage of the total number of contracts available at the price that is represented by the size of the Member's proprietary interest. Because time priority has no impact on a Member's allocation, ISE Member's have no incentive to respond quickly to a broadcast message at the current or an improved price. The first Member to respond to the broadcast message at the current price will receive the same allocation as the third Member to respond at the current price, even if the aggregate of the responses of the first two Members are sufficient to fill the Agency Order. As a result, Members that wish to participate at the current price may wait until the last instant to respond. As a result, Members that are

⁵ The ISE has proposed changes to its rules regarding the Block and Facilitation Mechanisms, *See* File No. SR-ISE-2003-07. The BSE notes that even if the proposed changes are approved by the Commission, any quote or order received by the ISE during the Facilitation Mechanism which improves the ISE BBO will be displayed to the market. Therefore, the EAM will know that the market has improved upon its facilitation order and that the EAM will lose a part or all of the execution, at which time the EAM can cancel the facilitation. Under either version of the Facilitation Mechanism rule, the customer and not the EAM under takes the risk of the market moving against it. If the EAM ultimately chooses not to submit the Agency Order to the PIM, then the customer has lost the opportunity for price improvement.

willing to improve the price to get a larger allocation will not have any opportunity to recognize that their allocation has decreased and respond with a better price.

In contrast, the allocation of the execution to Improvement Orders in BOX's PIP is based upon price and time priority. As a result, BOX Options Participants have every incentive to respond quickly to a broadcast message at the current price and to improve the price. In the PIP, once there is enough volume of Improvement Orders to total 60% of the customer side of the order, any other Options Participants that wish to take part in the allocation must improve the price.^{6/}

Compare the results for the same order on the ISE PIM under two different timing scenarios:

- Order entered into the PIM is to sell 50 at 10.01 at 11 am. Assume no customers or orders on the book are due allocations.
- Members A, B, and C wish to participate only at the current price.
- Member D would improve the price to get a certain sized allocation.
- Member E would improve the price greater than Member D to get a certain sized allocation.

Example 1

- 11:00:01 Members A, B, C, D and E all respond at 10.01 for 20 contracts. If PIM were to end here, the CSO would get 20 contracts at 10.01 and each of Members A, B, C, D, and E would get 6 at 10.01. Message sent indicating the aggregate size of the best-priced Improvement Order is 50 at 10.01.
- 11:00:02 Members D and E realize that their allocation will be smaller than desired, and they each bid for 20 at 10.02.
 - If PIM were to end here, Members D and E would each get 20 at 10.02 and the CSO would get 10 at 10.01. Message sent indicating the aggregate size of the best-priced Improvement Order is 40 at 10.02.
- 11:00:02-03 Any Member that wants to grab the remaining 10 at 10.02 or improve the price has an opportunity to do so.

If no more Improvement Orders, then the customer is filled: 40 at 10.02 and 10 at 10.01

^{6/} See BOX Rules, Chapter V, Section 18(e) iii.

As seen by the example above, there is no incentive for Members A, B, and C to bid early. By bidding early, they effectively guaranteed that they would be outbid by other Members and lose out on any allocation. Another, more likely scenario permissible under the proposed PIM rules, is as follows:

Example 2

- 11:00:01 Members D and E respond at 10.01 for 15 contracts. If PIM were to end here, Members D and E would each get 15 at 10.01 and the CSO would get 20 at 10.01. Message sent indicating the aggregate size of the best-price Improvement Order is 30 at 10.01.
- 11:00:02 No responses. If PIM were to end here, Members D and E would each get 20 at 10.01 and the CSO would get 10 at 10.01. Message sent indicating the aggregate size of the best-price Improvement Order is 30 at 10.01.
- 11:00:029 Members A, B, and C respond at 10.01 for 15. There is no opportunity for any other Member, or for the CSO to respond.
 - When PIM ends, each of Members A, B, C, D, and E get 6 at 10.01 and the CSO gets 20 at 10.01.

Best case scenario for customer: 50 at 10.01.

Even though Members A, B, and C bid over two seconds later than Member D and E, their allocations are the same. Not only is there no incentive for Members A, B, and C to bid early, there is also no incentive for Members D and E to bid higher because Members A, B, and C might not have bid, and Members D and E might have received their desired allocation without needing to bid higher.

In addition, instead of improving the price, at any time Members can “game” the PIM system and increase their Improvement Order size so that they could receive a larger allocation, since allocation is based on size, not time. The PIM proposal merely fosters a continuation of the same “me too” attitude amongst market makers, which has hampered competition on the options exchanges for many years. This discourages price improvement and provides no benefit to the public customer.

Contrast the proposed ISE PIM to the BOX PIP: Under the BOX PIP, in Example 2, Members (Options Participants) A, B, and C would not have received any allocation. Because the BOX PIP allocation is based on time priority, all Options Participants are encouraged to improve early, which results in overall greater price improvement for the customer.

B. PIM 40% Allocation to EAM at Price Worse than Best Price Violates SEC Standard and Discourages Participation

Pursuant to proposed ISE Rule 723(d)(4), before any Member participates in the allocation of the PIM at the same price as the CSO, the CSO is guaranteed at least one contract, and up to forty percent of the initial size of the Agency Order, at the price of the CSO, even if the CSO is not the best price. The SEC has held every other options exchange to a higher standard. BOX's PIP rules provide that the facilitating Options Participant is only entitled to a guaranteed percentage based on what is left at the Options Participant's best price level.^{7'} This higher standard exists for two very important reasons. First, if the CSO receives a guaranteed percentage (40%) of the Agency Order even if the CSO is not quoting the best price, the EAM has no incentive to better its price to compete with the other Members and encourage overall price improvement for the Agency Order, and the customer will receive a price worse than it might have otherwise received. Second, because the EAM has such an advantage over other Members, other Members will not want to participate in the PIM.

Using Example 1 from above, whereby:

- Order entered into the PIM is to sell 50 contracts at 10.01 at 11 am. Assume no customers or orders on the book are due allocations.
 - Members A, B, and C wish to participate only at the current price.
 - Member D would improve the price to get a certain sized allocation.
 - Member E would improve the price greater than Member D to get a certain sized allocation.
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- 11:00:01 Members A, B, C, D and E all respond at 10.01 for 20 contracts. If PIM were to end here, the CSO would get 20 at 10.01 and each of Members A, B, C, D, and E would get 6 at 10.01. Message sent indicating the aggregate size of the best-priced Improvement Order is 50 at 10.01.
 - 11:00:02 Members D and E realize that their allocation will be smaller than desired, and they each bid 20 at 10.02. If PIM were to end here, Members D and E would each get 20 at 10.02 and the CSO would get 10 at 10.01. Message sent indicating the aggregate size of the best-priced Improvement Order is 40 at 10.02.
 - 11:00:02-03 Any Member that wants to grab the remaining 10 at 10.02 or improve the price has an opportunity to do so.

^{7'} See BOX Rules, Chapter V, Section 18(f) i.

**If no more Improvement Orders, then the customer is filled: 40
at 10.02 and 10 at 10.01**

Even though Members A, B, and C were bidding at a price equal to the CSO, they did not receive any allocation of the customer order. As a result, Members A, B, and C, are less likely to participate in future PIMs. And if they do participate, they will bid as late as possible which, as discussed earlier, discourages price improvement. Without their participation, the price for the customer is less likely to be improved.

Furthermore, the 40% guarantee in proposed ISE Rule 723(d)(4) appears to be based on the amount of the original order, **not** the amount of the contracts remaining after all customer orders have been satisfied. Although ISE's proposal is similar to ISE's current facilitation mechanism in this regard, the facilitation rules of every other options exchange provide that the facilitating Member's guarantee only applies after all customer orders have been satisfied; i.e., the percentage of the guarantee is based on the amount of the remaining contracts, **not** the amount of the original order.⁸ Otherwise, the trading crowd would be competing for less than 60% of any order, which, in the similar context of specialist guarantees, the Commission has expressed concerns about.⁹ The Commission should not feel compelled to allow ISE's PIM proposal to provide for the same guarantee as ISE's Facilitation Mechanism. ISE should be held to the same standard as BOX's PIP - the guarantee should be a percentage of the amount of the contracts remaining at the CSO's price level after all customer orders have been satisfied.

C. PIM Broadcast Provides Insufficient Information for Aggressive Bidding

In the PIM broadcast, the only information provided to Members is the aggregate size of the best-priced Improvement Orders (proposed ISE Rule 723(c)(4)). As a result, Members do not have enough information to make fully informed decisions about how to compete for the Agency Order. It would be helpful for Members to know information about all of the competing orders that could potentially receive some of the allocation. If a Member that was quoting the second best price could calculate the amount of its

⁸ See CBOE Rule 6.74(d)(ii), PCX Rule 6.47(b)(4), Phlx Rule 1064(d)(ii).

⁹ See Securities Exchange Act Release No. 49068 (January 13, 2004) 69 FR 2775 (January 20, 2004) ("The Commission has generally found specialist guarantees to be consistent with the Act as a reasonable means for an exchange to attract and retain well-capitalized specialists that are responsible for assuring fair and orderly markets and fulfilling other responsibilities. The Commission has more closely scrutinized proposals, however, where the percentage of specialist participation would rise to a level that could have a material adverse impact on quote competition within a particular exchange. See, e.g., Exchange Act Release No. 4311 (July 31, 2000), 65 FR 48778 (August 9, 2000) (Phlx's "80/20" proposal, which the exchange ultimately withdrew, would have increased its enhanced specialist participation to 80% for certain options orders) ("Phlx 80/20 Notice"). In particular, the Commission is concerned that large specialist guarantees could significantly discourage intramarket price competition by "locking up" such a large proportion of each order that market makers in the crowd would be seriously hindered in their ability to compete with the specialist. Over the long-term, the decrease in intraexchange competition could widen spreads and diminish the quality of prices available to investors. Id.")

allocation at that price, that Member could decide to improve its price or increase its size. If a Member knew that the EAM had improved the CSO, the Member could compete against this better price. Not having all of this information available limits the opportunity for the Agency Order to receive the best price possible.

For all of these reasons, we do not believe best execution obligations can be satisfied by sending an order through ISE's proposed PIM process.

III. THE ISE'S FACILITATION MECHANISM RULE FOR ORDERS OVER 50 CONTRACTS CANNOT CO-EXIST WITH THE PROPOSED PIM

ISE Rule 716(d) provides a method by which ISE Members can facilitate orders for fifty contracts or more. This method has two very significant differences from the PIM:

- First, *the facilitation price is not required to be at or greater than the NBBO*. Therefore, the execution price of the facilitated order will usually be less if the facilitation takes place through ISE Rule 716(d).
- Second, *a facilitation order can be cancelled*. If the size and price of competing orders exceeds the facilitation price, meaning the facilitating Member will lose the order, the facilitating Member can cancel the order.

For these reasons, the election of a PIM is always better for the customer than a facilitation pursuant to ISE Rule 716(d); and a facilitation pursuant to ISE Rule 716(d) would always be better for the ISE Member than the election of a PIM. However, because there are no restrictions on which facilitation method ISE's Members would be able to use, for orders over fifty contracts, ISE Members could always try first to facilitate an order pursuant to ISE Rule 716(d), and if it appears as though the ISE Member would lose its 40% guarantee, the ISE Member could cancel the facilitation order and then elect the PIM. Alternatively, the EAM can solicit orders for the counterside of the Agency Order. Using the information from the solicitation process, the EAM can then decide which facilitation process to utilize.

Because the potential for abusing the availability of both options exists, the ISE should only have one facilitation process available. As such, the ISE's proposed PIM would need to replace, rather than coexist with, the ISE's current Facilitation Mechanism.

IV. THE PROPOSED PIM RULES ARE CURSORY AND LEAVE ESSENTIAL ISSUES UNADDRESSED

In approving the BOX trading rules the Commission and the Staff worked with the BSE to ensure that the PIP system was described in detail in the description section of the BSE

rule proposals^{10/} as well as the rules themselves.^{11/} An improvement auction like the PIP raised many issues (SEC Rule 11(a), customer information protection, InterMarket Linkage, etc.), that had to be addressed by specific provisions in the BOX trading rules, yet the proposed ISE PIM rules don't address these issues and the ISE omits discussion of many of these items.

A. ISE PIM Rules Lack Any Discussion of the Critical Issue of Exactly How Members Can “Solicit” Other Members to Interact With Customer Orders That Are Designated for the PIM, and What Procedural Protections Will Be Used to Protect Customer Orders from Abuse

The ISE PIM rules say EAMs can “solicit” another Member or multiple Members to act as counterparty to a customer order the EAM represents as agent, but they provide no detail whatsoever about the requirements and procedural protections that are necessary to ensure that customer orders are provided with adequate protection from abuse. The common industry practice is for brokers to solicit orders when they are trying to fill large customer order, usually over 300 contracts or more. Since the PIM would be available to all size orders, the BSE does not understand why EAMs want or need to solicit CSOs for Agency Orders under 50 contracts.

Because of the many issues the price improvement process raises, such as protection of customer information and preventing broker-dealers and market makers from selectively using the PIP, the Commission required BOX to codify the Directed Order process and create many procedural protections in that process as well as the PIP.^{12/} ISE does not have a Directed Order process and has proposed no procedural safeguards whatsoever for the solicited CSO except vague references. The following is a list and explanation of the deficiencies of ISE's proposal in this regard.

- **The ISE PIM Rules Do Not Describe Who Can Be Solicited**

Who can the EAM solicit to be the CSO? Is it just another ISE Member for its proprietary account or can it be a Member acting as agent for a public customer who can act as counterparty to the Agency Order? Can it be an ISE market maker or a Member acting as agent for non-Member broker dealers or market makers?¹³ If the Member is acting as agent for a customer, how is this done? How is the customer

^{10/} See Securities Exchange Act Release No. 48355 (August 15, 2003), 68 FR 50813 (August 22, 2003).

^{11/} Id.

^{12/} See BOX Rules Chapter VI, Sections 5(b) and (c).

¹³ There does not appear to be any rule preventing the PMM or market maker from also submitting Improvement Orders in the same PIM in which it has part or all of the CSO.

order that is to act as the CSO to be handled by the EAM before a PIM is begun? Does it have to be represented on ISE's book? Isn't there the risk that the EAM will be competing against the orders it solicited? What prevents the EAM from using information about the solicited orders to predict the amount of price improvement necessary for the EAM to garner a high percentage of any PIM trade allocation and step ahead of the solicited orders or to decide not to submit the order to the PIM after all but rather to submit the order to the Facilitation Mechanism with no guaranteed price improvement over the NBBO? If an ISE market maker can be solicited, what safeguards are in place to prevent the market maker from using information about the pending Agency Order and the PIM?

- The Rules Do Not Describe How the Solicitation Process Works

There appear to be only two possible mechanisms for how the solicitation process for the PIM works, both of which present very significant questions:

1. The EAM holds the customer order (the eventual Agency Order) while it solicits another Member(s) to act as counterparty (the "Delay Method").
2. The potential counterparties somehow indicate to the EAMs in advance that they are willing to participate in a PIM (the "Previous Indication Method").

If ISE plans to utilize the Delay Method, where the EAM is to hold the customer order while soliciting the counterparties, how long can the EAM hold the customer order? Who manages the communication amongst the EAM and the solicited parties? ISE or the Members? Is the customer order represented in the market while the EAM holds it? Does the ISE have any rules or procedures that prevent parties who are being solicited from abusing their knowledge of the potential customer order? How and in what form is the entire process documented by the EAM for record-keeping purposes? Additionally, we would assume that the ISE has demonstrated to the Commission that it has adequate surveillance and compliance procedures in place to monitor the EAM's duty of best execution to the customer order and to detect any abuse of the customer orders by the EAM or the solicited parties. Traditionally, solicitation has only been allowed when a Member is representing a large order. The BSE does not believe there is justification to delay handling a small customer order (under 50 contracts) while an EAM tries to solicit a CSO. Beside the concerns mentioned, during that time delay the market can move away from the customer, denying the customer not only price improvement, but perhaps even execution.

If the ISE plan to utilize the Previous Indication Method, where the EAM somehow knows in advance of starting a PIM the potential counterparty interest, how is this information shared and communicated? Who manages these communications, ISE or the EAM?

Pursuant to either method, will the solicitation process be manual or electronic?

- The ISE PIM Rules Do Not Describe Whether and How The EAM Manages the Bidding for the Solicited Counterparty While the PIM Auction Takes Place

What terms are given to the EAM by the solicited counterparty prior to the EAM submitting the CSO? Does the EAM manage the auctioning after the initial Improvement Order is submitted? If so, how is this done and how is the EAM's conflict of interest with the solicited order mitigated?

- The Rules Do Not Describe Any Procedural Mechanisms to Protect Customer Orders from Being Disadvantaged

The BOX Directed Order process contains many explicit protections that are not present in the proposed PIM solicitation process. BOX manages the communication of the Directed Order. Market makers must decide in three seconds whether to PIP a Directed Order. In addition, BOX market makers cannot decline to PIP an order so that they can trade it at NBBO. If the market maker is quoting at the NBBO and declines to PIP an order, the market maker must wait three seconds before executing against the Directed Order, during which time all other market participants are able to execute with the order.^{14/}

The proposed ISE PIM rules do not address any of these issues. Nothing in the proposed rules prevent:

- An ISE market maker or EAM from misusing customer information with regard to the Agency Order or the solicited orders;
- An EAM from declining to utilize the PIM process after soliciting orders so they can trade with the customer at NBBO; or
- A PMM from declining to utilize the PIM process because it will get a higher allocation if the Agency Order is under 5 contracts.
- If ISE's Answer to Some of These Questions Is That Market Makers In The Class Are Not Allowed To Initiate the PIM Process, Then This Raises Serious Concerns About Whether PIM Is Really Designed To Provide Real Price Improvement Or Is Simply An Order Flow Provider Internalization Scheme

On BOX, any Options Participant can solicit any willing market maker to provide price improvement through the Directed Order process, whether or not they have any relationship. Any market maker that accepts directed orders from any Options Participant must accept directed orders from all Options Participants.^{15/} Thus, the

^{14/} Id.

^{15/} See BOX Rules, Chapter VI, Section 5(c).

BOX PIP is much more than just an order flow provider internalization mechanism. If the ISE PIM cannot be used to solicit a market maker to provide initial price improvement, then it looks much more like a pure internalization scheme, available to only a few EAM firms.

B. ISE PIM Rules Do Not Describe How Multiple Counterparties Can Be Represented in the Same Counter Side Order

The PIM rules provide that an EAM can solicit multiple counterparties to fill the CSO but contain no explanation on how this is done or managed. Can a single counter-side order contain interest from parties having different capacities, such as market maker, broker-dealer, customer, non-Member broker dealer? If so, how is this consolidated CSO managed? Order types usually do not allow for indication of multiple order origin codes. How would the solicitation process work if multiple parties were being solicited? Does the CSO order show how many counterparties are combined into the order? How is the CSO handled if multiple counterparties are willing to provide price improvement at different prices? How is the initial CSO order handled as well as any subsequent price improvements? Can a Member being solicited, act as the counterparty partially for its own account and partially as agent for another? How is this handled? If multiple counterparties are combined into a single order, how is allocation handled and by who? Is it up to the EAM to allocate? How does the ISE enforce proper allocation since it does not know who was included in the initial CSO order or for what size? What if the multiple solicited CSOs are for Members in different capacities and/or differing account type? Is it up to the EAM or the Member to properly allocate the trade? Again, how does ISE intent to surveil and enforce compliance with the rules relating to the PIM process?

C. The PIM Proposal Lacks Essential Detail on the Bidding Process During the PIM

Yet another area where the ISE's proposed rules regarding their PIM process is grossly deficient is in the lack of information and detail regarding the bidding process during the PIM. There is no description of what information is even supplied in the broadcast at the start of the proposed PIM. In contrast, the BOX Rules describe in detail the information which is included in the broadcast message disseminated prior to a PIP, including information regarding the series, size, price, side of market, and when the PIP will conclude.^{16/} Such information is essential for market participants to determine whether and how they will participate in the price improvement process. Without it, ISE Members would barely even know a PIM is commencing, much less intelligently decide whether to participate.

^{16/} See BOX Rules Chapter V, Section 18(e).

Moreover, the proposed PIM rules do not specify that, once a proposed PIM has commenced, whether the initial CSO can be reduced in size if it is improved in price. The BOX PIP rules, on the other hand, specifically state that a participant who submits a Primary Improvement Order (BOX's version of the CSO) is not permitted to cancel or modify the size of its Primary Improvement Order at any time during the PIP, and may only modify the price by improving it.^{17/} The BSE instituted this part of its PIP rules as an important customer protection. Without such a provision, a customer order submitted to the proposed ISE PIM would not be guaranteed a fill for the entire quantity of their order at a penny better than the NBBO. Such guaranteed improvement forms the basis for the BOX PIP, and if ISE desires to mimic the PIP, these types of important customer protections should be in place. Likewise, the ISE lacks a similar provision present in the BOX PIP Rules which specifies that a Market Maker that submits an Improvement Order may only reduce the size of an Improvement Order by improving its price.^{18/}

The ISE's proposed PIM rules are also silent on whether competitors in the PIM can submit Improvement Orders once or multiple times. Such descriptive information must be included in any set of rules which attempt to copy a mechanism as innovative as the BOX PIP. Without it, would-be followers of the PIP could disadvantage both customers and their own Members. The BOX PIP process was carefully developed, not in a vacuum, but in the context of the larger BOX Market, with broad based customer protections built in. These same types of protections must be followed for any market centers which attempt to copy the BOX PIP model, as the BOX PIP rules are only a piece of a wider marketplace, designed to offer customers the best-priced and fastest executions. The PIP cannot be segregated and pieces of it cherry-picked by other market centers, it must be considered in light of the total exchange's marketplace.

D. ISE PIM Rules Do Not Describe How Improvement Orders from Customers Are Defined or Handled

Proposed ISE Rule 723(c)(2) states that Improvement Orders may be entered by all Members for their own account *or for the account of a Public Customer*. ISE's proposed rules do not define Public Customer Improvement Orders; nor do ISE's proposed rules provide any detail about how a public customer's interest in participating in a PIM will be communicated to an ISE Member, or how the ISE Member will know how to handle the Public Customer Improvement Order throughout the PIM process. The ISE must allow customers to compete for orders entered into the PIM. Without any more detail about Public Customer Improvement

^{17/} See BOX Rules Chapter V, Section 18(e)(ii).

^{18/} Id.

Orders, the public cannot evaluate the quality, or even the reality, of a Public Customer's ability to compete for these orders.

Since only ISE Members receive the PIM broadcast under the proposed PIM, the BSE does not understand how a Public Customer can react in three seconds to something it cannot see without the ability to place a standing order. If such standing instructions are what is intended, than these should be treated in the same manner as on the BOX or they would be hidden customer interest that is not displayed to the market. Further, the BSE does not understand how the Public Customers could participate in the PIM since the generation of electronic orders is a violation of ISE's own Rule 717(f), as discussed more fully below.

When the BSE recently proposed the BOX PIP, the Commission required BOX's rules to address each of these issues. Pursuant to BOX's rules, a Public Customer Improvement Order is called a CPO. The terms of each CPO include (1) issue; (2) size; (3) a price stated in rounded five cent or ten cent increments, as appropriate, at which the order will be placed in BOX's book; and (4) a specific price stated in one cent increments which represents the greatest price the Public Customer wishes to participate in any PIP that may occur while its order is on BOX's book (the "CPO PIP Reference Price").^{19/} Throughout a PIP, the BOX Options Participant that holds the CPO on behalf of the Public Customer is required to submit (and modify) the Public Customer's interest as instructed to the PIP up to the CPO PIP Reference Price.^{20/}

ISE's process certainly does not need to be identical to the BOX PIP. However, ISE does need to provide the same level of detail about its process so that the public has an opportunity to evaluate and comment on that process. In addition, ISE's rules do not state how the customer's interest will be reflected in ISE's book.

E. ISE Proposed PIM Rules Do Not Require That PIM Executions Be Better Than the NBBO and Certain PIM Executions Would Be in Clear Violation of the Linkage Plan

The Commission required that the BSE include in the BOX PIP rules requirements that Improvement Orders may not be executed unless the price is better than the NBBO at the commencement of the PIP, except in special circumstances when BOXR determines quotes in one or more particular options classes in a market are not reliable.^{21/} The BSE has this provision so that PIP trades are compliant with the InterMarket Linkage Plan. Since the ISE PIM rules do not contain these requirements, the BSE questions whether all PIM executions would be compliant with the InterMarket Linkage Plan.

^{19/} See BOX Rules Chapter V, Section 18(g).

^{20/} See BOX Rules Chapter V, Section 18(g)(v).

^{21/} See BOX Rules Chapter V, Section 18(k).

The BSE also believes the proposed PIM is inconsistent with the InterMarket Linkage Plan, because in at least one instance a PIM execution could trade through another exchange's market. When an inbound market or marketable limit order on the opposite side of the order submitted to the PIM process terminates the PIM, the execution price will be the mid point between the best counter-side price²² and the ISE best bid or offer. If the NBBO quote is better than that mid-point price then a trade through has occurred. For example, assume the NBBO is 2.00 bid and 2.05 offer and ISE's quote is 2.00 bid and 2.10 offer, a PIM is started for an Agency Order to sell 100 contracts and after 2 seconds an inbound market order to buy 10 contracts terminates the PIM. The execution price will be the mid point between the best counter-side price, in this case let's assume 2.02, and the ISE best offer of 2.10, for an execution price of 2.06. This would be a trade-through of the NBBO of 2.05.

The BOX trading system and the PIP rules prevent trade-throughs in this type of situation in the BOX PIP. Furthermore, an inbound marketable unrelated order on the opposite side of the customer order being improved should not terminate the price improvement process, unless it is for the full size of the customer order (as is the case on BOX). Assuming the same example as above for a BOX PIP, the unrelated order would be checked by BOX's unique NBBO filter mechanism. Since the NBBO offer is 2.05, BOX would immediately execute the unrelated order at 2.04, one penny better than the offer, with the customer order in the PIP. The remaining 90 contracts of the customer order would continue to be given further price improvement opportunity until the PIP ends. The BSE sees no justification for the ISE PIM rules to allow an ordinary incoming market or marketable limit order to trade through the market in violation of the InterMarket Linkage Plan and ISE's own Linkage rules.

F. The Proposed PIM Rules Do Not Sufficiently Describe Allocation Process When PIM Is Terminated Prematurely and Incoming Orders Outside the PIM Are Executed Against Improvement Orders

The proposed PIM rules state that when an inbound unrelated market or marketable limit order on the same side of the market as the Agency Order submitted to the PIM process terminates the PIM, the marketable order will execute against any unexecuted Improvement Orders after the Agency Order is executed in full. The proposed PIM rules do not describe what the priority is among the excess Improvement Orders in executing against the unrelated marketable order. Is it the same priority as for the rest of the PIM? Are Public Customers and non-Member broker-dealers given priority over Members? If the initial CSO was not fully executed with the Agency Order, does the 40% preference for the CSO extend also to the excess quantity available to the unrelated marketable order?

²² The BSE assumes that "best counter-side interest" stated in the PIM rule includes all Improvement Orders from all sources and not just the improved Counter-Side Order.

The BSE also believes that because the proposed ISE PIM rules allow Improvement Orders to be executed against inbound unrelated market or marketable limit orders on the same side of the market as the Agency Order submitted to the PIM process, the proposal violates the Firm Quote Rule. Since the proposed PIM rules provide that Improvement Orders are available to inbound orders to the ISE market, then under the Firm Quote Rule this interest should be displayed to the market. However, the PIM rules do not provide for the display of Improvement Orders to the whole market, those who would benefit by the excess interest and might react to it, but rather just ISE Members.

G. How Is Customer Priority Over Non-Members Handled?

Pursuant to proposed ISE Rule 723(d)(1) and (2), Public Customer interest in the PIM is executed in full before orders for the account of non-Member broker-dealers are executed. We do not understand why non-Member broker-dealers should be discriminated against.

Section 11(a)(1)(G) of the Exchange Act and Rule 11a1-1(T) thereunder, makes it unlawful for any Member of a national securities exchange to effect any transaction on such exchange for its own account unless such Member grants priority to any bid or offer at the same price for the account of a person who is not, or is not associated with, a Member, irrespective of the size of any such bid or offer or the time when entered. Orders for the account of a person who is not, or is not associated with, a Member, may include Non-Customer Orders. The rule does not require public customers to be treated preferentially to other non-Members.

V. THE PROPOSED PIM RULES ARE INCOMPATIBLE WITH OTHER ISE RULES

In addition to being unworkable with existing ISE rules, such as the existing facilitation rule, the ISE's PIM, as proposed, would not be permitted under ISE Rule 717(f). ISE Rule 717(f) prohibits customers from creating and transmitting orders electronically without manual input unless such orders are non-marketable limit orders to buy (sell) that are priced higher (lower) than the best ISE bid (offer). The proposed PIM rules would violate this provision of the ISE Rules due to the fact that:

- in order to compete meaningfully in the proposed PIM, an ISE Member would need to electronically generate an order, and
- Improvement Orders in the proposed PIM would be marketable orders because they would trade against the customer side of the Agency Order and do not improve the ISE market (i.e. would not be priced higher (lower) than the best ISE bid (offer)).

Therefore, Improvement Orders in the proposed PIM would not fit within the exception ISE defines in its own rule. Yet, ISE Rule 717(f) is one of the few rules on the ISE which provides customer protections, and its elimination in favor of approving the proposed PIM should not be permitted, particularly in light of the absence of any other protections for customer orders within the proposed PIM.

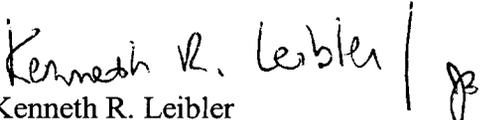
CONCLUSION

Due to the myriad of deficiencies with and omissions in ISE's proposed PIM rules, the BSE urges the Commission not to approve the proposal in its current form. The BSE is very concerned about the lack of customer protections in the proposal and the absence of basic details which essentially make the proposed rules unworkable in practice. If the ISE does not address the widespread issues we have raised, we further urge you to institute disapproval proceedings.

Furthermore, the BSE notes that its BOX PIP is currently approved on a pilot basis, and is being evaluated on an ongoing basis by the BSE and the Commission. The BSE believes that the proposed PIM is premature given the pilot status of the BOX PIP, and that the PIM proposal should be withdrawn until the BOX PIP has been approved on a permanent basis. As such, the PIP process could be fully tested, proven, and refined in the marketplace before being copied by other market centers.²³

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

Sincerely,


Kenneth R. Leibler
Chairman and Chief Executive Officer
Boston Stock Exchange, Inc.

cc: Chairman William Donaldson
Commissioner Paul Atkins
Commissioner Raul Campos
Commissioner Cynthia Glassman

²³ The BSE notes that the BOX Market has not been able to participate in the \$2.50 strike price pilot program of all of the other options exchanges due to unforeseen capacity problems which have arisen during that pilot program. Likewise, the ISE PIM proposal should not be approved until the BOX PIP has been fully evaluated for its impact on the marketplace.

Commissioner Harvey Goldschmidt
Annette Nazareth
Robert Colby
Elizabeth King
Deborah Lassman Flynn
Susie Cho
Steve Williams
John Roeser