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June 23, 2004

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

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Re: File No. SR-ISE-2003-06

Dear Mr. Katz:

This letter is in response to a comment letter submitted by the Boston Stock Exchange ("BSE") and its wholly-owned subsidiary, Boston Options Exchange Regulation LLC ("BOXR") regarding the above-referenced rule filing (the "BSE Letter").[1] The BSE Letter makes erroneous assertions about the operation of the ISE market and the proposed Price Improvement Mechanism ("PIM") rules. While we do not agree with most of the comments contained in the BSE Letter, we do agree that the BSE properly characterizes the Boston Options Exchange ("BOX") price improvement period ("PIP") rules as "only a piece of a wider marketplace" and that its PIP "must be considered in light of the total exchange's marketplace."[2] Similarly, we have designed the proposed PIM to complement our unique market structure, which we believe will make the PIM more beneficial to customers than the alternative provided by BOX.[3]

As we will explain in detail below, the BSE fails to raise any significant legal or policy issues with respect to our proposed PIM. First we discuss some general principles regarding our PIM and our market structure. Then we discuss each specific concern the BSE raised in its letter. We urge the Commission to approve our proposal as quickly as possible to allow us to offer a competitive vehicle to the BSE's PIP.

[1] Letter from Kenneth R. Leibler, Chairman and CEO, Boston Stock Exchange, Inc., dated March 24, 2002 ("BSE Letter").
[2] BSE Letter at pg. 16.
[3] The BSE suggests that the ISE not be allowed to provide a competitive facility to its PIP until PIP has been approved on a permanent basis. This suggestion is anticompetitive and inconsistent with the purposes of the Exchange Act to foster competition among markets.

The PIM is Well Tailored for the ISE's Market Structure

The BSE argues that because the ISE has a different market structure it fails to provide the same types of customer protections and competitive quotation incentives as BOX, and therefore we should not be permitted to offer a price improvement mechanism. We believe that our market structure, which gives public customer orders priority over non-customer orders and quotes, provides far greater customer protection than BOX's pure time-priority structure that rewards market participants with the fastest quotation system. Moreover, our market model has proven to result in the narrowest, most competitive quotes among all of the options exchanges today.[4] Regardless of which model will prove to be competitively superior, the Commission has found that both structures have potential benefits and that both structures are consistent with the requirements of the Exchange Act.

The BSE also argues that our market structure will discourage anyone from entering orders into a PIM. This discussion is misguided and fails to accurately characterize the operation of the ISE market and the proposed PIM. For example, with respect to allocations in the market, a primary market maker ("PMM") in our market does not trade against any orders unless it is competitively quoting. Therefore, there is no assurance that it will execute against any particular orders, whether from an affiliate or others, much less any guarantee of a particular percentage of orders it does execute against. Moreover, a PMM cannot "retain" small customer orders to price them at the NBBO or any other price, as orders are automatically executed against the best bids and offers in our market.[5] Therefore, we do not agree that our market structure will discourage members from entering orders into the PIM for potential price improvement, and we believe that offering additional opportunities for price improvement will be positive for investors.

With respect to the proposed PIM itself, the BSE argues that because the first participant to quote at a certain price is not given priority, there is no incentive for participants to respond quickly or to improve the price. Again, we do not agree that price-time priority achieves better prices for customers and believe, due to our experience in almost four years of operations, that rewarding market participants based on price and size creates the right incentives to produce competitive bids and

[4] A study by the Commission found that ISE was at the best bid and at the best offer, and alone at the best bid and offer, significantly more frequently than any other options exchange. Exchange Act Release No. 34-49175 (Feb. 9, 2004), 69 FR 6124 at footnote 35. ISE's own market analysis indicates that ISE quotation spreads are narrower than or equal to the spreads on the other options exchanges over 94% of the time.

[5] The BSE also made erroneous comments regarding other aspects of the ISE proposal: (1) under the proposed rule, only Electronic Access Members may enter Counter-Side Orders, not PMMs; and (2) the Facilitation Mechanism is described inaccurately. With respect to the Facilitation Mechanism, it does not create an opportunity for manipulation, as the order is broadcast for potential price improvement and responses are not known to the member who entered the order. Accordingly, a member cannot cancel a facilitation order if it fears it may lose a large portion of the order to the trading crowd because it has no way of knowing what percentage of an order it might receive. Moreover, the Exchange has proposed in a separate rule filing to eliminate the requirement that price improvement be provided only through orders on the book.

offers.[6] None of the examples provided in the BSE Letter are valid, as they ignore the incentive for a market participant to improve the price in order to potentially increase its participation in the trade.

<u>Response to BSE's Specific Comments</u>

Below we list the BSE's specific comments on the proposed PIM rule and provide our response to each:

- *The Counter-Side Order will receive a guaranteed allocation of 40% of an order even if it is not at the best price.* This is an inaccurate characterization of the ISE's rule. No trade occurs on the ISE other than at the best price. Under Rule 723(d) (Execution), an order is executed "in full at the best prices available, taking into consideration orders and quotes in the Exchange market, Improvement Orders and the Counter-Side Order." Paragraph (d) then describes the priority in which an order will be executed at the best price: (1) first against Public Customer Orders; (2) then against non-member broker-dealer orders; and (3) then against member proprietary interest. Paragraph (d)(4) states that in the case where the Counter-Side Order is at the same price as member proprietary interest in paragraph (d)(3), it will be given 40% of the order or at least one contract. Thus, price priority is always maintained.[7]
- *The 40% guarantee to the Counter-Side Order is based on the initial size of the order, which is a lower standard than has been applied by the Commission with respect to facilitation rules on other exchanges.* While it is true that the 40% guarantee is based on the initial size of the order, this is consistent with the standard that has been applied by the SEC with respect to facilitation rules. Market participants are competing for at least 60% of the order. The fact that a public customer may be among the competitors bidding and offering for the order does not change this fact.
- *The proposal does not specify what information is contained in the initial broadcast message.* The initial broadcast message will contain the series, the price, and quantity of the Agency Order, and whether the Agency Order is to buy or to sell. In Amendment No. 2 to the proposal, the Exchange clarifies this point in the text of the proposed rule.

[6] *See supra* note 4.
[7] The BSE also questions whether providing customer orders priority over non-member broker-dealer orders is consistent with Section 11(a)(1)(G) of the Exchange Act and Rule 11a1-1(T) thereunder, which requires members to yield priority to non-member orders. By definition, Public Customers are non-members, as are non-member broker-dealers. Thus members are yielding priority to all non-member interest.

- *The PIM broadcast provides insufficient information for aggressive quoting because it will consolidate the aggregate size for bids and offers submitted during the three-second exposure period.* While it is true that we propose to broadcast only changes in the best price and changes in the aggregate size of the best price, we believe that this approach will encourage price improvement. While it might be useful for a participant to know the prices and sizes below the best price, this information only helps a member determine whether it can receive its desired allocation without matching or improving the best price.

- *There are no rules dictating how members solicit orders.* Solicitation is an "upstairs" practice that results in a crossing transactions being brought to the Exchange. Like facilitations, all of the options exchanges have rules requiring that this type of crossing transaction be exposed to the trading crowd. Inclusion of solicited crosses in addition to facilitation orders in the PIM simply provides another way in which members can expose these types of crossing transactions. This raises no new or unique regulatory issues and does not require detailed rules regarding this longstanding practice.

- *There are no specific procedural mechanisms with respect to directed orders.* This statement is true since we are not proposing to allow directed orders *in this rule filing*. Under current ISE rules, market makers are not allowed to handle any agency orders. The Exchange has proposed to allow Electronic Access Members to direct orders to market makers *in a separate rule filing*[8] which contains specific procedural mechanisms and rules to permit directed orders.

- *Because ISE has not provided the opportunity for market makers to receive directed orders, the PIM is a "pure internalization mechanism."* We do not understand this comment. As we commented when the BSE proposed to allow orders to be directed to market makers, the handling of customer orders by market makers raises additional regulatory issues, not fewer issues. Specifically, such order routing arrangements are typically tied to payment for order flow incentives.

- *The proposal does not require that orders be entered into PIM at a price that is better than the NBBO.* This is not true. Proposed paragraph (b)(1) contains this requirement.

- *The proposal does not contain particular requirements regarding how customers may participate in a PIM auction.* This is true. Unlike the BOX's PIP, we have not limited the ability of public customers to participate in the price-improvement auction to the narrow circumstance where they have pre-defined interest with a special order type that is only operative if they are at the NBBO at the time a PIP auction is initiated. Thus, unlike the BSE, we do not need to include in our rule provisions limiting customer participation in the PIM.

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[8] *See* SR-ISE-2004-16 filed by ISE with the Commission on May 19, 2004.

Under our proposed PIM, a customer may participate in a PIM auction whether or not they have an existing limit order on the ISE book at the NBBO. Our members can represent customers in a PIM under any type of instruction they wish to accept without restriction. This will greatly increase the opportunity for customers to participate in PIM auctions.

- *The proposal does not specify whether an Improvement Order can be modified.* This is not true. Proposed paragraph (c)(3) provides that an Improvement Order may be modified to (1) increase the size at the same price, or (2) improve the price of the Improvement Order for any size up to the size of the Agency Order. The rule is permissive and by construction does not allow for any other modifications, including reducing the size of an Improvement Order at the same price.
- *The execution of unrelated orders on the opposite side of the market from the Agency Order could result in a trade-through of the NBBO.* This is not true. The intent of this aspect of the PIM functionality is to provide added opportunities for price improvement to both the unrelated order and the Agency Order. If the midpoint between the best-priced counter-side interest and the bid or offer on the Exchange would result in a worse price than the NBBO for the unrelated order, the trade between the unrelated order and the Agency Order would not take place. Rather, the unrelated order would be handled according to the normal procedures for providing away-market protection under Rule 803(c)(2). In Amendment No. 2 to the proposal, the Exchange clarifies this point in the text of the proposed rule.
- *The proposal does not describe how allocations will be made when an unrelated order on the same side of the market as the Agency Order is executed against unexecuted PIM interest.* These executions will follow the same execution priority rules described in paragraph (d)(1), (2) and (3). There will be no special priority for the Counter-Side Order. In Amendment No. 2 to the proposal, the Exchange clarifies this point in the text of the proposed rule.
- *The proposed PIM is inconsistent with ISE Rule 717(f) which prohibits the electronic generation of orders.* It is not the Exchange's intent to apply Rule 717(f) to orders entered into the PIM. We agree that if participants are not permitted to electronically generate orders to participate in the PIM, they cannot compete meaningfully in the process.[9] In Amendment No. 2 to the proposal, the Exchange clarifies this point in the text of the proposed rule.

As discussed above, the BSE Letter fails to raise any significant legal or policy issues with respect to our proposed PIM. Therefore, we respectfully request that the Commission approve the proposed rule change quickly so that investors will be able to benefit from this additional opportunity for price improvement.

[9] The BOX rules contain the same restriction on electronic generation of orders.

If you have any further questions on this proposal, please do not hesitate to call me.

Sincerely,

Michael J. Simon
Senior Vice President and General Counsel

cc: Annette Nazareth
Elizabeth King
Deborah Flynn