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STOCK EXCHANGE

Boston Options Exchange Regulation LLC
A Wholly-Owned Subsidiary of the Boston Stock Exchange

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

Re: File No. SR-ISE-2003-07

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 change its Block Order and Facilitation Mechanisms. Although ISE characterizes its proposal as simply one that provides for the entry of block and facilitation trades at the midpoint between the standard trading increments, ISE's proposal completely changes the operation of these two order execution mechanisms. The implementation of these changes would reduce liquidity on the ISE and diminish the likelihood of price improvement. In addition, the proposal discriminates among broker-dealers and violates Rule 11(a) of the Securities Exchange Act of 1934 ("Exchange Act"). For these reasons, the proposal is not consistent with the requirements of the Exchange Act, and we urge the Securities and Exchange Commission ("Commission") to institute proceedings to determine whether the proposal should be disapproved.

We believe this proposal is ISE's first assault upon the facilitation mechanism of the recently opened Boston Options Exchange ("BOX"), called the Price Improvement Period ("PIP"). In commenting on the proposed BOX rules, the ISE threatened that a "race to the bottom" would result if the BOX rules were approved. Through this proposal, ISE has shown its desire to win this alleged race and its willingness to forego meaningful customer protections and price improvement in favor of the firm seeking to facilitate orders.

Pursuant to proposed ISE Rule 716(d)(3)(ii), it appears as though the facilitating Electronic Access Member ("EAM") is guaranteed to execute at least forty percent of the facilitation order at the facilitation price, regardless of any Non-Customer Orders at the

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facilitation price. It does not appear[1] as though the EAM yields to any non-ISE Member Non-Customer Orders at the facilitation price. 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 ISE Member, may include Non-Customer Orders. By not granting priority to these orders, proposed ISE Rule 716(d)(3)(ii) is in violation of Section 11(a)(1)(G) of the Exchange Act.

As part of the development of the BOX rules, the Staff of the Commission worked with the BSE to ensure that priority was properly provided in BOX's facilitation mechanism (i.e the PIP) for broker-dealer orders from non-BOX Options Participants. The BSE expects the same requirements will be applied to the other options exchanges as they attempt, through rule proposals such as the present one that ISE is putting forth, to mirror or resemble the BOX rules, particularly in relation to the facilitation of customer orders. Imitation is flattery, but in the case of priority and order protection, the imitation must be complete, and not cherry-picked.

BOX's PIP has many provisions that protect customer orders that ISE's proposal lacks. For instance, the PIP Primary Improvement Order (similar to the facilitation order) and the competing Improvement Orders must always be priced at least one penny better than the NBBO, thereby guaranteeing customer orders price improvement over the NBBO. ISE's proposal does not have this provision. Pursuant to ISE's Facilitation Mechanism, ISE's proposed rules do not require the EAM facilitation price to even be equal to or greater than either the ISE best bid or offer ("BBO"), or the National best bid or offer ("NBBO"). Therefore, facilitated orders could be executed outside of the ISE BBO or NBBO, providing no price improvement to the customer order at all.

In addition, BOX provides electronic messages to all BOX Options Participants to provide details about PIP orders, including the price and size of the orders competing with the "facilitation" order. ISE's proposal does not provide for the dissemination of this type of information to ISE Members. ISE's proposed rule would allow Members to indicate a willingness to facilitate an order at an improved price equal to or better than the

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[1] We use the term "appear" because we cannot decipher the following language of ISE Rule 716(d)(3)(ii): "Responses, quotes and Non-Customer Orders at the facilitation price will participate in the execution of the facilitation order based upon **the percentage of the total number of contracts available at the best price that is represented by the size of the Non-Customer Order or quote**. This appears to be a fraction of some sort, but what the numerators and denominators are supposed to be is completely unclear. The only way for this ISE Rule to be in compliance with Section 11(a)(1)(G) of the Exchange Act is for the 40% guaranteed to the Electronic Access Member, to be taken from that portion of the original size of the facilitation order left after better-priced orders and quotes, Public Customer Orders at the facilitation price, and Non-Customer Orders from non-ISE Members at the facilitation price are executed.

ISE BBO without providing any information about these competing bids or offers to Members. The BSE believes that this lack of information is a disincentive for potential competitors and hinders any price improvement, which is compounded by the fact that the facilitation price is not required to be greater than the NBBO, or even at the NBBO.

The BOX rules allow the PIP initiator and the competitors to dynamically compete throughout the facilitation process, providing an auction and further price improvement opportunity. ISE's proposal does not permit this type of competition. The EAM and the competing ISE Members only have one opportunity to submit a price, restricting the potential price improvement that could be achieved.

Further, the ISE proposed rules provide that if Public Customer bids or offers on the ISE are better than the facilitation price, then they receive the facilitated price, thereby receiving the price improvement instead of the customer order being facilitated. The BSE does not understand how this provision is consistent with the ISE's stated purpose for proposing the rule, which is to "allow a greater opportunity for price improvement for large size orders." In addition, the BOX rules prohibit the PIP initiator from canceling its "facilitation" order thereby guaranteeing the customer order price improvement. ISE's proposal does not have this prohibition. The EAM can cancel its facilitation order at any time during the process, leaving the customer order with all the market risk and potentially unexecuted. In all, ISE's proposal falls far short of the protections and price improvement guaranteed on BOX. We question whether the ISE's Facilitation Mechanism results in a better price to the customer than the customer would have otherwise received outside the Facilitation Mechanism.

In proposed Paragraph .05 to Supplementary Material to ISE Rule 716, the ISE proposes to prohibit any Responses for the account of an options market maker from another options exchange. It's not clear how the ISE defines an "options market maker from another options exchange." Is the ISE referring to any entity that has an affiliate (e.g. specialist/DPM unit) that acts as a market maker on another options exchange, or is the ISE referring just to the unit that acts as a market maker on another options exchange? If it's the former, then the ISE has eliminated a great deal of potential liquidity and price improvement for the Block and Facilitation Mechanism by excluding its members with market maker affiliates on other options exchanges. If it's the latter, then ISE's proposed rule violates Section 6(b)(5) of the Exchange Act which prohibits the rules of an exchange from being designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

ISE opines that this discrimination is fair because ISE market makers are not given an opportunity to participate in trades executed on the floors of the other options exchanges and that its market makers would be at a competitive disadvantage if options market makers from other exchanges were given the opportunity to participate in trades executed on the ISE. The BSE agrees with the ISE that the current lack of opportunity for "away" market makers to participate in trades executed on the floors of the other options exchanges is unfair, perhaps even in violation of securities rules, and is the result of differing market structures. However, this situation should not be used as an excuse to compound the problem. BSE would like to note that ISE market makers, indeed all exchange market makers, are always permitted to participate in the facilitation mechanism (PIP) on BOX, as well as in the entire BOX trading system. Therefore, BOX market makers would be unfairly excluded from participating in the ISE Block and Facilitation Mechanism. BSE also believes that ISE proposes to exclude Responses for the accounts of market makers from other options exchanges because they are sophisticated traders with whom EAMs and ISE market makers do not wish to compete for orders. This is the traditional reason for the exchanges denial of "away" market maker participation in other situations as well. If ISE is permitted to exclude market makers from other exchanges from its Block and Facilitation Mechanism, than BOX would be forced to do the same for its PIP process.

ISE's proposal includes several amendments to its rule text that remain unexplained.

- In ISE Rule 716(d)(1), ISE proposes to replace "Public Customer order" with "order". What is the significance of this change?

- In proposed paragraph .05 to Supplementary Material to Rule 716, ISE refers to "Solicited Order" Mechanisms. What are these Mechanisms? We find no definition or description of this system in the ISE Rules.

- In proposed paragraph (d)(3)(i) to Rule 716, ISE proposes to delete "on the Exchange." The BSE does not understand the purpose of this deletion. If Public Customer and Non-Customer bids or offers are not "on the Exchange" at the time the facilitation order is executed, then where are they?

The BSE also believes that the proposed ISE rules do not address how incoming options Intermarket Linkage orders interact with the Block and Facilitation Mechanism and the order being submitted to the Mechanism.

Another issue which is completely unexplained is how the ISE would report the proposed Split Price trades. It is not clear that the Options Price Reporting Authority ("OPRA") is prepared to report Split Price trades, particularly considering that the issue of Split Price trades also introduces the concept of subpenny trading into the options arena. If the ISE is attempting to introduce subpenny trading into the options arena, then the BSE would ask that the Commission seek additional comment separately on this issue, and delay action on this proposal until the issue of subpenny trading in the securities market is resolved. The Commission has just proposed in new Regulation NMS to eliminate subpenny trading in equities. The BSE believes it is inconsistent for the Commission to approve the ISE proposal for subpenny trading while at the same time it seeks to eliminate the practice for the equities market.

Finally, we are surprised that no other market participant has commented on this proposal, either to express support or disagreement. We suggest that the Commission extend the comment period to encourage a complete discussion of the important issues raised by this controversial proposal.

Please do not hesitate to call us if you have any questions on our comments. Again, we urge the Commission not to approve ISE's proposal.

Sincerely,

Glenn Verdi
Chief Regulatory Officer
Boston Options Exchange Regulation

cc: Chairman William Donaldson
Commissioner Paul Atkins
Commissioner Raul Campos
Commissioner Cynthia Glassman
Commissioner Harvey Goldschmidt
Annette Nazareth
Robert Colby
Elizabeth King
Deborah Lassman Flynn
T.R. Lazo
Ann Leddy