

February 12, 2003

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

**Re: File No. SR-BSE-2002-15; Release No. 34-47186**

Dear Mr. Katz:

The International Securities Exchange, Inc. ("ISE") appreciates the opportunity to comment on this filing. While we believe that the Boston Stock Exchange's ("BSE") proposal for the Boston Options Exchange ("BOX") could add competition to the market, which we view favorably, the BOX application raised significant policy issues under the Securities Exchange Act of 1934 (the "Exchange Act").<sup>1</sup> We can summarize our comments as follow:

- **Conflicts of Interest:** The BSE rules are riddled with conflicts of interest. While the rules nominally require a separation of market making and order-entry functions, or a Chinese Wall, BOX also will let market makers "receive and handle Customer Orders on an agency basis." The filing specifically states that market makers "may attempt to interact with their own orders...." We fail to understand how a market maker walled-off from a firm's order flow provider ("OFP") function can handle customer orders. As proposed, the rules would permit a BOX market maker to guarantee itself at least 40 percent of any and all customer orders it wants through the Price Improvement Period ("PIP"), while having the tools to avoid trading against any order it deems unattractive. As a general matter, BOX has grossly inadequate protections required by the Securities Exchange Act of 1934 ("Exchange Act") against potential abuses of a person acting as both a broker and a dealer.
- **Specialist System:** BSE states that it does not have specialists. At the same time, the BSE rules state that all BOX market makers are deemed specialists for the purposes of the Exchange Act. The filing is thus inconsistent on its face. Either the BSE will need to treat all BOX market makers as "specialists" for *all* purposes of the Exchange Act, or it will need to amend its filing to delete the attempt to provide its market makers with specialist status.
- **Internalization:** The PIP would allow members to trade against their own order flow at prices better than the national best bid and offer ("NBBO"). Conceptually, we do not disagree with the BSE's general proposal of a short, price-time priority auction to provide customers with

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<sup>1</sup> BOX will operate as a facility of the BSE. Throughout this letter we refer to the BSE when discussing the entity making the filing and the self-regulatory functions that the BSE will conduct on behalf of BOX; we refer to BOX with respect to the trading system itself.

price improvement. Properly balanced, this could: provide benefits to investors; give OFPs a reasonable opportunity to trade against their own order flow; and retain for market makers and other exchange crowd participants significant trading opportunities. However, the PIP proposal does not properly balance competing interests. Indeed, approval of the PIP in its current form, with the likely competitive responses from the other exchanges, could seriously damage the options auction market process. We object to: the inclusion of orders of all sizes within the PIP; the fact that the PIP violates the Firm Quote Rule (Rule 11Ac1-1 under the Exchange Act) by not disseminating PIP "bids" and "offers" to the market as a whole; and the "Market Maker Prime" concept, which, together with the guarantee to the internalizer, can "lock up" more than half an order before the crowd generally can compete for the trade. We also believe that the Commission should require that BOX limit the use of the PIP to those options series in which there are at least five market makers making continuous quotations. That will help protect against BOX simply becoming an internalization engine. Outside of the PIP, the rules governing BOX do not provide sufficient protection against firms internalizing their order flow since there is no requirement that members wait a specified time before trading against their customer orders.

- **Linkage:** The five existing options exchanges are implementing an intermarket linkage ("Linkage") mandated by the Commission.<sup>2</sup> Each of these exchanges has filed rule proposals with the Commission to implement the Linkage. While the BSE has indicated its intention to join the Linkage, BOX's flat-book, non-specialist trading system is not consistent with the Commission's approved Linkage structure. Moreover, Linkage rules so permeate an exchange's operation that it is impossible to analyze BOX's other rules until we can review BOX's linkage proposal. Thus, the Commission should not approve the BSE's filing until the BSE files its Linkage rules and we have an opportunity to review those rules and comment on the entire rules package.
- **Best Execution:** In BOX's flat-book system, customer orders have no priority over professional orders. If a BOX member sends a non-marketable customer limit order to the BOX, all orders BOX previously received at that price – including professional orders – will have priority. Had BOX addressed the inherent conflicts in its proposal, such a market structure may pass regulatory scrutiny. However, as noted above, BOX specialists act as both dealers and agents, raising serious regulatory concerns. But even if BOX were to address these concerns, other options exchanges give customer orders priority over professional traders. Thus, we fail to see how a broker-dealer ever could comply with its best execution obligation to a customer if it sends a non-marketable limit order to an exchange that does not grant customers priority. The Commission should make this clear in any order approving the BSE filing.

In addition to these concerns, we believe that the BSE must revise or clarify the following aspects of the BSE filing:

- **Market Orders:** BOX introduces a concept of a "market order" different from the commonly-understood industry definition. In all current markets, a market order must be executed immediately and in full. On BOX, if there is not sufficient trading interest in the book to fill a market order at the initial price of execution, the "market order" turns into a limit order on the book. We believe that this will be confusing to customers. While BOX should be free to offer this type of order, it should explain the rationale for this new type of order and it should not confuse it with traditional market orders.

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<sup>2</sup> Securities Exchange Act Release No. 42029 (October 19, 1999) ("Linkage Order").

- Pricing: The BSE rules provide that non-market makers who transact principal business (or agency business for other broker-dealers) more than two times the amount of the customer business must pay a "surcharge to be determined by the Board." The BSE gives no basis for this surcharge, which on its face appears discriminatory and anticompetitive. The BSE will need to file BOX fees for notice and comment prior to commencing operations, and we believe it would be inappropriate for the Commission to approve this rule provision until there is a full vetting of the BOX fee schedule.
- Inconsistencies: The filing is not consistent with BOX's promotional material. For example, the BOX web site describes a request-for-quote process that may violate the Firm Quote Rule. In addition, the web site's discussion of the PIP describes its operation in a manner that is inconsistent with the proposed rules. Based on these disclosed inconsistencies between BOX's proposed operation and the BSE's proposed rules, we are concerned that there may be other inconsistencies between how BOX will operate and this filing. Thus, not only does the BSE need to address these disclosed discrepancies, the Commission should carefully audit BOX's proposed functionality to ensure that it complies in all respects with its rules. The BSE should amend the BOX rules as necessary to conform to BOX's operation, and the Commission should republish those amended rules for comment.

This is only a brief summary of our concerns with BOX. While the Commission's recent Market Structure hearings on October 29, 2002 and November 12, 2002 equity market hearings received wide publicity, there was very little discussion of the options market. Had the options market been subject to these hearings, and had we been invited to present our views on BOX, the transcript for the hearing may have been similar to the one we enclose as an attachment to our comment letter.

We urge the Commission not to approve the proposal in its current form. If the BSE does not address the issues we have raised, we urge you to institute disapproval proceedings. If you have any questions on our comments, please do not hesitate to give us a call.

Sincerely,

Michael J. Simon  
Senior Vice President and Secretary

Attachment

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

Annette Nazareth  
Robert Colby  
Elizabeth King  
Stephen Williams

Attachment

## **Transcript of SEC Hearings on Options Market Structure**

Location: David Saperstein Auditorium, New York City

Date: January 26, 2003

Participants:

SEC: Larry Robinson, Associate Deputy Director, Division of Trading & Exchanges:

ISE: Kevin Constantine, Executive Vice President for Strategic Planning

BOX: Jacques Lemaire, Special Assistant to the Senior Special Counsel

### **Introduction**

SEC: Good morning. The Commission recently held two days of hearings on the market structure for equity securities. Today we cover a much different market structure: the U.S. options market. In the equity markets we have eight registered exchanges, one registered association, and numerous electronic communication networks trading the same securities. Yet, at least for listed securities, trading is concentrated in one primary market that executes up to 85 percent of the volume. The equity market has active "upstairs" trading in informal markets, and no restrictions on internalization as long as broker-dealers comply with their best execution obligations.

In contrast, listed options trading occurs only on one of five registered options exchanges, four of which operate trading floors, and the all-electronic ISE. In addition, the BSE is seeking to register its electronic market, BOX. Competition is fierce among these exchanges. Also, some aspects of market structure long taken for granted in the equity world are now first appearing in options: firm quotes, quotes with size, an NBBO, and a market linkage. Most of these changes have resulted from increased competition in the market over the last few years.

In the options world, there are strict limits on internalization: the Commission has approved "facilitation rules" only for block trades, and only if they limit the amount of an order withheld from the trading crowd to 40 percent. Even then, there must be adequate opportunities for crowd interaction with the order. This is intended to balance the interests of order flow providers – OFPs – who seek to provide liquidity to their order flow, and market makers and other crowd participants, who seek to interact with order flow in order to provide continuous, two-sided liquidity to the market. Ensuring that significant order flow is available for interaction with the trading crowd is critical to a successful auction system.

The five currently-registered exchanges, whether or not they operate a floor, all have a specialist or equivalent dealer with certain trading responsibilities, together with competing market makers providing additional liquidity and member firms sending customer order flow or trading for their own proprietary accounts. Even before all exchanges had specialists, they had "order book officials" who handled customer orders, separating dealer and agency functions. Into this mix, the BSE proposes a flat-book system, with relatively strict price/time priority. All orders will be on equal footing, with no special priority for customer orders. The proposal also includes the "PIP," which we will discuss in detail this morning.

Today's opening panel will focus on BOX, and contains a BOX representative, as well as a representative of the only current screen-based exchange, the ISE. To begin, I call on the BOX representative to give an overview of this market.

BOX: BOX will be an options market where orders from all types of market participants may interact directly with each other on a price/time priority basis. Through the PIP, BOX would attract orders and subject them to price improvement and real price competition without which they would otherwise simply be executed at the NBBO. BOX would offer a price/time priority based limit order book where any Public Customer or broker-dealer market participant could submit orders or take liquidity. BOX would have multiple and competing market makers rather than a specialist system. There would be no designated specialists, primary market makers, or lead market makers with authority to control trading in a particular options class. This structure will result in better pricing since the price and time priority algorithm gives a strong incentive to trading Participants to post their very best prices rapidly. This competition would encourage tighter spreads and better pricing to the ultimate advantage of the investor.

### **"Flat-Book" Trading System and Conflicts of Interest**

SEC: ISE, what do you think of the proposed "flat-book" system? Do you see any regulatory concerns with such a structure?

ISE: In our view, simply applying the standards of the Exchange Act and the rules thereunder, there does not appear to be an outright prohibition against a "flat book" where broker-dealers with time priority can trade ahead of customers at the same price. Of course, that does raise the policy issues for the Commission to consider. But leaving that aside for the moment, please note that BOX is not proposing a non-specialist system. In Chapter VI, Section 1(c) of the BSE's Rules, they specifically state that BOX market makers "are designated as specialists on BOX for all purposes under the Exchange Act or Rules thereunder"! It seems to us that the BSE wants it both ways: they want to call BOX market makers specialists so they get the benefits of the Exchange Act. For example, an important benefit of being a specialist is that, pursuant to Regulation M under the Exchange Act, a firm can continue to trade in a security (or option overlying a security) while the firm also is involved in an underwriting of that security.

Yet there is a "price" to pay to be a specialist. Of most importance, pursuant to Section 11(b) of the Exchange Act and Rule 11b-1 thereunder, specialists generally cannot trade for their own account ahead of customer orders. That certainly is not the BOX proposal, where strict price-time priority often will have its specialists trading at a given price before customer orders are executed. If the BSE wants to defend a flat-book system without customer priority, fine, but they should actually be proposing that. Let all members have equal standing for both proprietary and customer orders, without any classifications of their members. At the Commission's recent hearings on the equity market Richard Bernard, the General Counsel of the New York Stock Exchange, made some very valid points on the very nature of what constitutes an "exchange" and the minimum standards an entity must meet to qualify as an exchange. We question whether BOX meets those standards.

SEC: But I think you miss the point here. The regulation of specialists, and the "trading ahead" rules, address concerns when a person acts as both dealer and agent.

ISE: BOX market makers can act as both dealer and agent.

SEC: BOX, is that true?

BOX: Market Makers may receive and handle Customer Orders on an agency basis. Market Makers may trade as principal as contra party to Customer Orders submitted to BOX by such Market Maker; however, Market Makers may only seek to act as contra party to their own Customer Orders pursuant to the rules of the PIP.

ISE: That is what Chapter VI, Section 5(b) of BOX's Rules states. Yet Chapter V, Section 10 of the BOX rules contains language just like ISE Rule 810, requiring a separation of, among other things, a BOX Option Participant's market making and OFP functions, or a Chinese Wall. However, the very last paragraph of that rule, paragraph (h), states that notwithstanding the Chinese Wall requirement, market makers may receive and handle customer order flow. Perhaps I need to be able to operate at a higher order to understand the interplay of these two provisions, but a market maker that truly is walled-off from the firm's OFP function would not be able to receive and handle customer orders, let alone enter those orders into a PIP. Effectively, the BSE negates 99 percent of the purpose of the Chinese Wall rule in that last paragraph.

This raises significant policy issues. BOX would appear to allow market makers to handle customer orders while the trading algorithm would *require* the market maker to trade ahead of a customer if the market maker is first at a price. In addition, there are obvious conflicts of interest in having both functions combined. When the market maker receives an order it likes, it simply can use the PIP, which we will discuss later, to guarantee itself 40 percent of the order. When the market maker receives an order it does not like, it can change its quote to move out of the way of the customer order that it is about to enter. These are exactly the types of conflicts the Exchange Act prohibits.

I must note a basic issue here before it gets lost in our list of concerns: The BSE does not even propose a Manning-type rule, similar to NASD Rule IM-2110-2, prohibiting BOX market makers from trading ahead of their customer orders. Talk about violating Section 11 of the Exchange Act!

We leave it to commentators much more learned than us to remind the Commission of the history of the Exchange Act, including the contributions of Mr. Saperstein, for whom this room was named. But the Exchange Act is intended to protect investors against the conflicts that arise when a broker-dealer acts as both dealer and agent. Here the BSE claims it is introducing a flat trading system without specialists. Yet the rules themselves define the market makers as specialists, and are ripe with conflicts and potential abuse. Most fundamentally, these market makers can act as both dealer and agent, without the necessary Exchange Act protections in place. The Commission should insist that BOX strictly separate market making and order-entry activities.

SEC: The Commission will need to consider these conflicts of interest more closely, and we certainly will take your views into consideration. Are there other aspects of the flat-book system you find troubling?

ISE: While I don't know if I'd call it troubling, we believe that the BOX proposal raises best execution issues. As most recently stated in the "Order Handling" release, which was issued on September 9, 1996 in Release No. 34-37619A, the

Commission has reminded broker-dealers that they must continually analyze their order-routing decisions to help ensure best execution for their customers. The Commission noted a particular concern for limit orders, stating that "in evaluating its procedures for handling limit orders, the broker-dealer must take into account any material differences in execution quality (**e.g., the likelihood of execution**) among various markets or market centers to which limit orders may be routed." (We added the emphasis.) Talk about a textbook example of that principle! If an OFP sends a non-marketable limit order to BOX, that order will stand behind any professional trading interest already on the book at that price. In contrast, on the ISE the customer order always has priority at a given price, regardless of the time of entry. Thus, BOX's proposed market structure would result in an OFP automatically violating its best execution obligation by sending a limit order to BOX unless the OFP – on an order-by-order basis – first made sure that there was no preexisting professional order on the book. So even if the Commission ultimately finds itself comfortable with this general flat-book approach, any approval order would need to make this point so that OFPs know the inherent risk of trading on BOX.

- SEC: Please put that concern in your comment letter, so we formally have it on the record. I have a feeling you are not done with your "flat-book" issues.
- ISE: Certainly not, and speaking of different order types, in reading the BSE rules I'm not sure I understand the concept of such orders any more. Chapter V, Section 14(c)(ii), of the rules defines a "market order" as an order that is executed at the best available price on BOX until all available volume at that price is exhausted. At that time, the order "is automatically converted to a limit order at the price at which the original market order was executed." There are two problems here. First it is confusing. In every other market, a market order is entered to trade immediately "at the market." That apparently is not the case on BOX, and calling this a market order certainly will confuse investors who reasonably expect timely executions of market orders. Second, BOX fails to address a problem that likely will arise on its markets: without any guaranteed liquidity in an options series, there could be some series without quotes at all. That is, blank screens. What will BOX do with market orders for such series? We certainly would expect the Commission to require the BSE to explain this order type much better.

### **Internalization and the Price Improvement Process**

- SEC: That is a point we obviously will have to address as we review the comment letters. I'd like now to discuss perhaps the most controversial aspect of BOX, the PIP. Would the BOX representative explain to us the rationale for the three-second exposure, the penny pricing, the inclusion of all-sized orders in the PIP, and the PIP guarantees.
- BOX: The PIP auction process would be three seconds in duration because BSE believes it is enough time for a vigorous, multi-round, electronic price improvement auction among BOX market makers and the OFP who initiates the PIP, and yet is not so long that it is economically infeasible for OFPs to be firm for the Customer Order for at least a penny better than the prevailing NBBO at the inception of the PIP.
- ISE: If I can jump in here, I want to be on record with agreeing with the BSE on at least one point. Our "Facilitation Mechanism" shares some similarity with the PIP, and we originally required a 30-second exposure period. We proposed to

reduce this period to five seconds in filing SR-ISE-2001-19. We thought we were being conservative here since, like the BSE, we believe it is possible to have a vigorous electronic auction within a few seconds, certainly three. Seven months after we filed this rule change, the Commission staff told us they would be comfortable only with a 10-second period, and we so amended our filing. Nine months after we made this change, the Commission approved the 10-second exposure. If the Commission thought 10 seconds was needed for our Facilitation Mechanism, we question how the Commission can approve a three-second PIP. Our Facilitation Mechanism is simply a single-response procedure, without multiple rounds of price improvement like PIP, which requires dissemination of new prices and responses to those prices. While we believe that three seconds is reasonable for the PIP, we also believe it is reasonable for us. We would expect that if the Commission approves this proposal, it will find three seconds reasonable for all similar electronic auctions.

BOX: During the PIP, the price increment for orders is one cent rather than the usual five or ten cents. Note however that the penny increment is available only to Market Makers on the class to which the PIP instrument belongs and the OFP who has initiated the PIP. All other parties may enter orders, but in the usual five and ten cent increments.

SEC: ISE, do you have any issues with penny pricing here?

ISE: Yes and no. As a general matter, we understand the rationale for having a PIP auction inside the standard increments. This does raise some market structure issues, and we are troubled by the potential long-term effect of moving to pennies in options. A more immediate problem with this aspect of the BOX proposal is limiting penny pricing to market makers, and only those market makers in the series being PIPed. This obviously is discriminatory on its face. While the Exchange Act does not outlaw discrimination entirely, Section 6(b)(5) does prohibit "unfair discrimination between customers, issuers, brokers or dealers." Allowing only a select group of market makers to compete effectively for an order appears to us to be unfair. These market makers can calculate the "fair value" of an option and enter their orders in pennies at prices they know others cannot compete against using nickels and dimes. Because the BSE makes no attempt to justify this discrimination, the filing fails to provide a regulatory justification to support approval of this provision. At a minimum, the Commission should require the BSE to amend its filing, and then give commentators an opportunity to respond to any justification the BSE attempts to provide.

SEC: Other than this discrimination issue, are there any other areas where you see direct conflicts with the Exchange Act or its rules?

ISE: How about a violation of the Firm Quote Rule? During the three-second PIP auction, BOX is disseminating bids and offers internally to BOX participants, but not to the investing public.

SEC: BOX, is that true?

BOX: Improvement orders will be displayed to BOX Options Participants, but will not be disseminated to OPRA for the purpose of the calculation of the NBBO.

SEC: What is the problem with that?



ISE: Section (a)(2) of the Firm Quote Rule defines a bid or offer as a price communicated by an exchange member to any other person. Clearly, the Primary Improvement Orders and other PIP Improvement Orders are prices communicated to BOX participants. Once you have such a bid or offer, section (b)(1)(i) of the rule clearly requires an exchange to collect these bids and offers and to make them available to quotation vendors. BOX is not proposing to do so, in what appears to us to be in direct contravention of the rule. While the BSE always can request an exemption from the Firm Quote Rule to authorize this hidden auction, we are hard-pressed to see a basis for any exemption. The purpose of the rule is to provide the investing public with a full and true sense of the market for a security. Hiding auctions so only professionals have access to the true market is directly contrary to this purpose. We recognize that the minimum increment for options quotes currently is either five or 10 cents, not pennies. But that alone would not justify violating the quote rule. There is a strong public policy goal of providing all market participants with full information. Once you start providing different classes of participants different information you necessarily create an unequal playing field that calls into question the integrity of the market.

SEC: But how is this different from your Facilitation or Block Mechanisms, where responses to proposed facilitations or blocks are not included in your quote?

ISE: Apples and oranges. In our market, we do not disseminate the responses to facilitations or blocks, so there is no "communication" that gives rise to the quote-dissemination requirement. In fact, if someone wants to price improve a facilitation, they have to enter a quote into the market that is displayed to all, and which all can hit. Simply put, we comply with the Firm Quote Rule and they don't.

SEC: Any other "dissemination" issues?

ISE: Yes. The BOX representative stated in his opening remarks how BOX's structure:

will result in better pricing since the price and time priority algorithm gives a strong incentive to trading Participants to post their very best prices rapidly. Indeed, BOX's competition would encourage tighter spreads and better pricing to the ultimate advantage of the investor.

In its filing, the BSE similarly stated that "in contrast to some other systems, under the proposed BOX Rules no one would get a 'last look' to step up and match the prices bid or offered during the PIP."

Obviously, nothing can be further from the truth. Because BOX disseminates the prices during the PIP, it provides everyone a "last look" to grab priority by a penny. Moreover, the initiating OFP – and only the OFP – has a "last look" to match the last price. Thus, the OFP has no incentive to put forward its best price initially. Indeed, the OFP can attempt to "low-ball" the customer, knowing it always can retain 40 percent at the end of the auction. Since market makers also can handle customer orders and initiate PIPs, they can further abuse the system. They may actually place a customer order on the book during the PIP, and then join that order at the same price. Since BOX does not provide customers with priority, in that case the market maker would be taking 40 percent of the order away from its own customer! At a minimum, the BSE needs to

amend its filing to acknowledge that, indeed, there is a "last look" in the PIP, as well as the potential for market makers to trade ahead of their customers, and to explain how this complies with the Exchange Act.

SEC: Do you see any other statutory or rule violations?

ISE: Nothing so obvious, but we do have some other policy problems that we believe raise Exchange Act legal issues.

SEC: Well then, let's turn to policy. One area where the PIP differs from the facilitation rules of the other exchange involves the size of eligible orders. All current facilitation rules limit use of an exchange's facilitation systems to "blocks," which are orders of at least 50 contracts. BOX proposes a pilot period of 18 months in which there would be no restrictions on order size for the PIP. Why is that?

BOX: From the Customer's perspective, the only result of having the Customer's small order being ineligible for the PIP would be that that Customer's order would likely be filled at a price at least a penny worse than if it had been filled through the PIP. Indeed, because there is less relative risk to the OFP and Market Makers by virtue of the small size, the greater the likely price improvement is to be provided by BOX Market Makers stepping in and participating in the PIP. On the other hand, creating a minimum size requirement would mandate that all small orders are automatically executed at the prevailing quotes with no opportunity for any price improvement. Consequently, BOX would have no minimum size requirement for orders entered into the PIP, for at least a Pilot Period to extend eighteen months from the day trading commences on BOX. During this Pilot Period, BOX would supply the Commission with data to support at least the following tenets: (1) that there is meaningful competition for all size PIP orders; (2) that there is significant price improvement for all orders executed through the PIP; and (3) that there is an active and liquid market functioning on BOX outside of the PIP mechanism.

ISE: Note how BOX prefaces this entire justification by stating it is "from the customer's perspective." Indeed, BOX focuses only on the one specific order being internalized, a narrow view of the market. BOX completely ignores an important market structure issue: removing small customer orders from an exchange's general auction could adversely affect the auction generally and the pricing mechanism. Smaller customer orders are a foundation for the pricing mechanism, with market makers posting the best prices at which they are willing to trade with such orders. If the BOX proposal removes a significant number of these orders from the auction – and it is likely that the orders against which an OFP wants to trade will be the most attractive orders – there could be radical changes to the quotes market makers disseminate. We believe that, while quotes may remain tight, there will be much less size available. Market makers disseminate quotations in size in hundreds of series, providing liquidity for all takers. In contrast, BOX will allow OFPs to "cherry pick" attractive small orders without having to disseminate any quotations. The only way market makers on competing exchanges will be able to compete for this order flow will be to provide narrow quotations in all series, but smaller quotations to mitigate against the risk. This could seriously harm overall liquidity in the market, making quotations more "retail oriented," and stunting the growth of the listed options market in the institutional arena.

Moreover, if the Commission approves this proposal, I guarantee to you that the ISE will follow suit. As much as we may dislike this proposal, we currently are building it ourselves, and will have no choice but to follow suit if the Commission ultimately approves the PIP. Note how this worked in payment-for-order-flow, where four exchanges held their noses while filing "me-too" filings after the Commission permitted one exchange to implement an exchange-sponsored program. That has resulted in what Chairman Pitt clearly believes was a mistake, since on January 24, 2003 he sent all the options exchanges letters asking them to terminate not only their payment-for-order-flow programs, but also their internalization programs. We fail to see how the Commission can even consider approving a PIP for small orders in this environment.

SEC: Does the 18-month pilot for including small orders in the PIP address your concerns?

ISE: No. The damage will be done long before that. Besides, we don't understand the concept of a pilot here. As written, the rule provides that there is an 18-month pilot in which all-sized orders are included in the PIP. What happens after 18 months? If this "pilot" is not extended, are there limits on the size of orders that can be entered? If so, what are they? We believe that the PIP should be limited to block-sized orders from day one. If there is any pilot at all, the entire PIP program should be a pilot that will end unless the Commission extends or permanently approves it after analyzing the effects of the PIP not only internally to BOX, but on the options market generally.

SEC: ISE, any other PIP policy issues?

ISE: One PIP issue and one related internalization issue. There is an important inconsistency between the BOX web site and the BOX filing, dealing with trading in the "regular" market during a three-second PIP. According to the filing, trading will continue outside the PIP during these three seconds, with the only exception being when BOX receives another order on the same side of the customer order being internalized. In that case, the PIP terminates and both orders trade out. That is fine. But what happens if BOX receives an order on the *other* side of the market? Assume that the market is 2.05 to 2.15, and there is a ongoing PIP where a customer is selling and an internalizer is willing to buy at 2.08. During the PIP's three seconds, BOX receives an unrelated order to buy the same option. At what price does that customer buy? If you read the BOX filing, it would appear the new customer would buy at 2.15, notwithstanding the fact that there supposedly is an on-going effort to try to get price improvement for the internalizer's customer (who is now slated to sell at 2.08). Why not match the two customers? On the BOX web site, their second PIP example is exactly this situation: the second customer would get price-improved to 2.14, matched against the customer being PIPed. That seems much more fair. Why did BOX include it in their web site, but not their filing? That gives us concerns that there are other discrepancies between the rules and how BOX actually operates.

SEC: We will take that under advisement. What is your related internalization issue?

ISE: The filing is quite "fuzzy" on internalization outside of the PIP. There are no real protections against BOX participants trading against their customer orders.

SEC: BOX, is that true?

BOX: Options Participants may trade as principal, both as contra party to Customer Orders submitted to BOX by such Option Participant and as contra party to other Options Participants' orders. However, Options Participants may only seek to act as contra party to their Own Customer Orders pursuant to the rules of the PIP. Similarly, market makers may only seek to act as contra party to their own Customer Orders pursuant to the rules of the PIP.

SEC: So what is the issue, ISE? If a BOX participant wants to trade against its own customer order flow, it must use the PIP.

ISE: The rules the BOX representative quoted apply only when an Options Participant, an OFP or market maker, "seeks" to trade against its own order flow. This establishes an unenforceable subjective standard as the only protection against unfettered internalization. In contrast, note how the ISE polices this area. First, ISE market makers are strictly prohibited from handling customer orders at all, so this issue does not arise with them. With respect to Electronic Access Members, the ISE's equivalent to OFPs, ISE Rule 717(d) states that an EAM may not trade against their own agency order outside of the ISE Facilitation Mechanism unless they either (1) first expose that order on the exchange for at least 30 seconds or (2) have been quoting at the proposed execution price for at least 30 seconds prior to receiving the agency order.

The ISE rule is clear-cut and easy to enforce. But what will happen on BOX? We already discussed the inherent conflicts if a market maker receives a customer order. The market maker would be able to adjust its quote, then enter the order. If the order hits the quote, the market maker could say it did not "seek" to trade against the order, but it just so happened to work out that way. Proving otherwise would require a subjective analysis of intent. It is similar with OFPs. If an OFP receives a customer order, what does the OFP have to do to avoid "seeking" to trade against it? Can the OFP put in its own proprietary order first, wait three seconds and then enter the customer order? Since BOX believes you can have a "vigorous" auction in three seconds, that may be sufficient.

The bottom line is that BOX's lack of specificity, and its subjective test, leaves the area wide open for abuse. To protect the integrity of the market, first BOX must prohibit market makers from handling customer orders. For OFPs, if they haven't had a proprietary order on the book for 30 seconds when they get the customer order, they should be required first to enter the customer order into the market, and then wait 30 seconds before trading against it.

SEC: Thank you. Now back to the final PIP issue – "guarantees" – and how an order is allocated. BOX, how will this work under your proposal?

BOX: At the conclusion of the three second PIP period, the customer order will be matched on a price and time priority basis with the orders on the opposite side of the market. There are however two exceptions to time priority. It should be noted that these exceptions are to time priority only, not price priority, and therefore have no effect on the final price to the customer order. Provided the OFP's professional order has matched the best price on the side of the market opposite the customer order, the OFP will be entitled to time priority over all other orders for a quantity of forty percent of the order. In some cases, there will be a Market Maker with time priority over the other market makers participating in a given PIP. Where a BOX Market Maker is posting an order equal to or better than NBBO on the BOX central limit order book at the instant that a PIP is

initiated and that Market Maker also has time priority on the BOX book ahead of any other BOX Market Maker order or quote, that Market Maker will be designated Market Maker "Prime" ("MMP") for the PIP. If the MMP participates in the PIP and at the end of the process he has posted an order which is executable against the customer order, his order will have a priority over those of all other participants, excepting the OFP, for up to one-third of the quantity available for execution at that price limit.

SEC: ISE, do you have problems with this proposal?

ISE: Yes. This proposal violates the limit the Commission has imposed on internalization: an exchange cannot allocate to members, and remove from the auction, more than 40 percent of an order due to members' "status." The problem is "market maker prime," where BOX carves out a third of an order for a market maker that is first to establish the inside market at the time of the PIP. Rewarding market makers that establish the inside market is fine, but not at the expense of the crowd. Here, assuming the OFP gets 40 percent of an order, the MMP gets one third of what is left, removing well over half an order from the crowd outside of BOX's supposedly strict price-time priority system. This is contrary to the "40 percent rule" the Commission staff has publicly announced at industry conferences and has imposed on all the other options exchanges. The Commission staff held us to this rule when it required that we not apply our general algorithm (giving slight preference to our Primary Market Maker) when we allocate a Facilitation Order after the entering EAM receives 40 percent of the order. As required by the Commission staff, after customers are satisfied and the entering EAM receives its 40 percent, we allocate all remaining portion of the order strictly based on size priority. Also, this proposal is not consistent with Chairman Pitt's January 24<sup>th</sup> letter, in which he seeks the termination of internalization programs, not the expansion of those programs. The BSE has not given any sound reason why the Commission should change its position here. Any guarantee to the MMP should come out of the OFP's 40 percent guarantee, and should not be in addition to it.

SEC: Any last words on PIP before we move on.

ISE: One last point: this proposal is radically different from anything the Commission has ever approved before. It appears that the BSE's underlying justification for all these changes is that BOX's low entry costs will result in many market makers providing a level of competition above and beyond that available on any other exchange. The BSE appears to be asking the Commission to accept this on faith. At a minimum, and to ensure that BOX really is a competitive market and not an internalization vehicle, the Commission should restrict the use of the PIP to any options series in which there are five market makers providing continuous quotes. If, over time, it appears that competition is not an issue the Commission can relax that requirement. However, until then we strongly believe that such a limitation is necessary to guard against the internalization concerns that gave rise to Chairman Pitt's letter.

### **Request For Quote ("RFQ") Process**

SEC: So much for the PIP. Any other policy issues?

ISE: We have a number. However, rather than get lost in a list of details during this hearing, we would like to concentrate today on major policy issues. We will

submit an Appendix to our testimony that will outline for you some specific comments we have on the BOX rules. For now, we would like to focus on one policy issue, an RFQ process, which does not appear in the filing.

SEC: BOX, will there be an RFQ process?

BOX: A user having trading access to the BOX market will be able to issue an RFQ, allowing him to signal his interest in a particular instrument. RFQ messages are included in the exchange's broadcast and as such are visible to all market participants. Responses to RFQs are live orders with the same treatment as any other limit order on the electronic order book. The issuer of an RFQ does not have any priority in execution against the orders responding to the RFQ. To execute, he must enter an order to the BOX trading engine. The issuer of an RFQ is under no obligation to enter an order after an RFQ.

ISE: That is clearly what the web site states, but I see no discussion of this in the filing or the rules. At a minimum, if BOX is planning to offer this function, it must provide for it in its rules. Only then can the Commission determine if the functionality complies with the law. For example, how long will responses to RFQs stay in the market? Will they be sent to OPRA? If not, there is the same Firm Quote Rule violation as with PIPs. We can't analyze this until BOX properly explains the framework of the RFQ. Moreover, as we noted before, this lack of consistency between the filing and how BOX will "really" operate is troubling. We obviously cannot tell what other discrepancies there may be between how BOX will operate and the published rules. We believe the Commission should closely review all aspects of BOX's proposed operation to ensure that the rules correctly describe BOX's operation.

## **Pricing**

SEC: Let's leave policy and explore what I hope is an easy issue. BOX, how do you plan to charge for your services?

BOX: BOX has low barriers to trading access. Options Participants, whether market makers or OFPs, or both, would not be required to obtain membership in the BSE, nor lease trading rights from any member of the BSE. Market Makers would be required to register as an Options Participant, obtain approval from the BSE and pay a modest annual access fee for trading rights and a low execution fee per contract. Also, an Options Participant, other than a Market Maker in its appointed classes, who transacts, as principal or as agent submitting orders on behalf of the proprietary account of other broker-dealers, more than two times the number of Public Customer contracts executed by such Options Participant in a given month shall pay to BOX a per contract surcharge to be determined by the Board.

ISE: I'm not quite sure I follow that last part, but the BSE's filing does state that it will file its fee schedule with the Commission, as it is required to do. Hopefully the BSE will provide a greater explanation of that "surcharge." When we first entered the options business, the Commission staff asked us to file our initial fees for "regular way" review and comment, rather than rely on the effective-on-filing provisions of Section 19(b)(3)(A) of the Exchange Act. Knowing how the Commission values a level playing field, we assume that you will require the same from the BSE. This is not just another fee filing from an existing exchange, the BSE. Rather, it is much more analogous to a filing by a new exchange that

should be published for comment prior to Commission action. That filing will need to detail the specific fees that BOX will charge, including the surcharge. We also expect that the fee filing will explain what this surcharge means, and how it is justified under the Exchange Act. On its face, it seems discriminatory and anticompetitive to penalize members – and only some members at that – for trading as principal as compared to their trading against customer orders.

### **Intermarket Options Linkage**

SEC: I'd like to raise one last issue: the intermarket Linkage. BOX, where do you stand on Linkage?

BOX: BOX is presently evaluating the Intermarket Linkage Plan. BOX fully supports the Plan's intent to ensure that clients obtain the best price available in the case of multiple listed options classes; however, certain elements of the plan, particularly the key role played by the specialist firms at each of the existing exchanges in the linkage implementation, will require more detailed evaluation by BOX. The BSE intends to file the necessary rule changes to allow the BSE to join the Options Intermarket Linkage Plan.

ISE: The options exchanges are implementing the Linkage as a direct result of the Commission's Linkage Order. As the Commission has made clear in the last three-plus years, it is absolutely critical that the exchanges build this Linkage, and that the exchanges provide strong protection to guard against, and correct, trade-throughs of customer orders. The five existing exchanges worked diligently throughout this process to develop a Linkage that meets all the Commission's requirements. We are encouraged that the BSE supports the intent of the Plan and intends to file Linkage rules. Indeed, in June, 2002, the BSE attempted to sign the Linkage Plan and formally become a party to that plan. However, the BSE was premature in doing so since it had not even filed its options trading rules with the Commission. Yet by attempting to sign the plan we assumed that the BSE was prepared to abide by its requirements.

SEC: Then you have no problems here?

ISE: We are concerned about how the BSE plans to participate in Linkage. It is clear to us that the BSE either will need to tailor its market structure to fit within Linkage, or it will need to present proposals to the Linkage participants for possible changes to the Linkage Plan to accommodate its market structure in a manner consistent with the overall thrust of our Linkage Plan. We are dismayed that the BSE has not yet spoken to the Options Linkage Authority, or OLA, about this. Until the Commission recently approved a Linkage Plan amendment providing potential new options exchanges with limited access to Linkage facilities, we recognize that the BSE did not have an automatic "seat at the table" at Linkage meetings. However, OLA invited the BSE to raise any questions or concerns that it may have. They have not done so. While we at the ISE are flexible in attempting to accommodate new market structures in the Linkage, the BSE needs to appreciate that the Linkage Plan represents a negotiated compromise among the parties. There are some critical elements of the Linkage Plan that we believe must guide any discussions with the BSE.

SEC: And what may they be?

ISE: The most important is the limitation on access. Section 8(b)(ii) of the Linkage Plan makes clear that Linkage is not designed to be an order delivery system

whereby all or a substantial portion of an exchange's customer orders are sent through the Linkage for execution. Similarly, the plan recognizes that each of the existing exchanges is a membership organization in which existing market makers, and in some cases all members, have spent significant amounts of money to purchase or lease trading rights. As approved by the Commission, only market makers acting as agent for customers – specialists or their equivalents – have the right to send principal acting as agent orders through the Linkage. Similarly, only market makers who have purchased or leased memberships on an exchange have the right to send Principal Orders through the Linkage. In contrast, EAMs on the ISE are similar to BOX's Options Participants, since they simply pay a nominal fee to trade on the ISE. However, our EAMs have no right to send Linkage orders.

We respect BOX's proposal to allow trading without seat purchases or leases, and without market makers having agency responsibilities for customer orders (at least other than their own orders that they hold). We certainly raise no objection to that market structure. However, we will strongly object to any proposal in which BOX simply becomes a conduit for members to send their customer orders through the Linkage to other markets – markets that do require acquiring memberships – when those markets post better prices. We similarly object to BOX market makers simply paying a nominal access fee to BOX to gain access to the Linkage so that they can send us their principal orders (although subject to the so-called 80/20 test in the Linkage Plan). This is a bed-rock principle of the Linkage against which we will evaluate any proposal the BSE may make. If the BSE is not prepared to operate under the Linkage as now in effect, we urge them to discuss this issue with OLA as soon as possible.

SEC: ISE, you had the last word.

*Note and Disclaimer: In the preceding fictional account of an options market structure hearing, all comments attributed to BOX are taken directly from the BOX filing, the BOX web site or the BOX rules (with a good faith attempt to state those positions in proper context). The comments attributed to the ISE represent the ISE's positions on the various issues discussed. The comments attributed to the SEC represent the ISE's best attempt to replicate what we would expect SEC staff members to say in a hearing of this type. We base this on years of listening to SEC staff comments in which the staff makes every effort to be honest, neutral and fair! We apologize in advance if we failed in that endeavor.*



## Appendix

### Analysis of Specific BOX Rules

#### 1. Participant Definitions.

Chapter I, Section 1 of the BOX rules ("Rules") defines an "Options Participant" as either an "Order Flow Provider" ("OFP") or "Market Maker" that is registered with the BSE pursuant to Chapter II of the Rules. An OFP is defined as a member that represents *as agent* Customer Orders (defined to mean orders of Public Customers or broker-dealers) on BOX. It is thus unclear from the Rules whether BOX will allow Options Participants to be proprietary trading-only firms, *i.e.*, broker-dealers that do not conduct an agency business. The ISE has many such members. If the BSE is proposing to prohibit proprietary trading-only broker-dealers from becoming Options Participants, it would be a significant limitation on access that must be justified under the Exchange Act. If the BSE is not proposing to limit Options Participants to OFPs or market makers, the Rules should be clarified.

#### 2. Applicability of BSE Rules.

Chapter I, Section 2(b) of the Rules state that the BSE rules generally apply to BOX, but "shall be interpreted in light of the nature of options trading and the BOX market, and the fact that options on BOX shall be traded electronically through the Trading Host." This open-ended statement does not give members sufficient guidance as to the governing rule structure and implies that BOX will adopt interpretations of BSE rules without filing them with the SEC as rule changes. As required under section 19 of the Exchange Act and Rule 19b-4 thereunder, the Commission should require the BSE to specify exactly what "stated policies, practices and interpretations" of the BSE rules will apply to BOX and to file any necessary new interpretations with the Commission for approval.

#### 3. Capital Requirements.

Chapter II, Section 2(d) of the Rules state that Options Participants must meet the greater of the BSE's capital requirements or the requirements of another options self-regulatory organization ("SRO") to which its Designated Options Examining Authority ("DOEA") requirements apply. We do not understand this provision. Broker-dealers must meet the capital requirements of all SROs of which they are a member. Moreover, the concept of a DOEA has to do with sales practice examinations, not capital requirements. The purpose and meaning of this proposed rule needs to be clarified.

#### 4. Adherence to Rules.

Chapter II, Section 2(e) of the Rules state that Options Participants must have the demonstrated ability to adhere to certain BOX rules regarding "trading, recordkeeping, confidentiality, systems capacity, etc." We do not understand the use of "etc." in this list. We are not aware of any other SRO ever imposing a requirement on a member to demonstrate compliance with unnamed rules. The BSE needs to specify the rules with which members will need to demonstrate compliance as a condition to membership.

## 5. Single Price Opening.

Chapter V, Section 9 of the Rules describes a single price opening "using market-on-open and limit orders." However, Section 14(c)(iii) of that Section defines a "Market on Opening" as an order executed "at the best **price(s)** available in the market until all available volume has been traded." (Emphasis added.) This appears to allow for multiple price openings and/or multiple price executions of "Market on Opening" orders. BOX should clarify whether a "market-on-open" order is the same as a "Market on Opening" order, whether the opening will be single-priced or multiple-priced, and how orders will be executed.

## 6. Trade Anonymity.

Section 14(e) of Chapter V of the Rules states that orders are anonymous. However, Section 16(a)(vi) states BOX will make available "on a delayed basis" counterparty details and that members must keep this information confidential. This provision is unique and needs further explanation. Counterparty information generally is not available until a trade reaches the clearing process. It would seem that this proposed rule would provide members with important information not generally available to the public. When will BOX provide counterparty details? What type of counterparty details will BOX provide? For what purpose is BOX providing this information? The BSE needs to provide a more detailed explanation of this proposal before there can be any analysis of whether the provision complies with the Exchange Act.

## 7. Obligations of OFPs in the PIP.

Chapter V, Section 19(b) of the Rules requires that OFPs "act with due skill, care and diligence, and that the interests of their Customers are not prejudiced" when executing orders in the PIP. We are not aware of any legal basis in the Exchange Act for this standard of care. It appears to us that the BSE is attempting to establish a standard of care that varies from the Commission's best execution standard. The Commission should not permit this, and should require all exchange participants to follow the same best execution standards.

## 8. Complex Order Priority.

Chapter V, Section 27 contains BOX's complex order rules. While similar to our Rule 722, there is a difference in the priority of orders. Under our Rule 722(b)(1), complex orders entered with net price increments that are not multiples of the minimum increments are not entitled to trade ahead of other interest at the ISE best-bid-and-offer. We believe all of the options exchanges' rules are uniform in this respect. While the BSE copied part of our Rule 722(b)(1) in Section 27(b)(1), they did not copy this exception to the priority rules. This would allow these complex orders to trade ahead of orders on the BSE book. In addition, it appears that the BOX complex order rule will allow the options leg of a stock-option combination to trade ahead of its book, which also is inconsistent with the rules of the other options exchanges. The Commission should require BSE to provide justification for giving these combination orders priority over established bids and offers in its market, as it has not permitted the existing exchanges to give these combination orders such priority.

## 9. Away-Market Protection

ISE Rule 714 provides that the ISE will not provide automatic execution of customer orders when there is a superior market on another exchange. The BSE did not include a similar provision in the BOX Rules. We fail to see how BOX possibly can comply with its Linkage obligation without such a provision. This is an area the BSE will need to address in its Linkage rules.

## 10. Number of Market Makers.

While BOX theoretically can have an unlimited number of market makers, Chapter VI, Section 1(c) of the Rules states that BOX can limit the number of market makers due to system constraints, capacity restrictions and "other factors relevant to the maintenance of a fair and orderly market." The basis of many of BOX's extraordinary market provisions is the supposition that there will be virtually unlimited market maker competition. Since this is so central to BOX's proposal, there is no basis for an open-ended provision allowing BOX to limit the number of market makers simply to maintain "a fair and orderly market." The Commission should require BOX to adopt specific guidelines regarding when they may deny approval of an application to become a BOX market maker or deny approval of appointments to options classes.

## 11. Lack of Quotation Obligations.

Chapter VI, Section 6 of the Rules contains the quotation requirements for BOX market makers. Unlike ISE Rule 804(e), BOX neither requires market makers to enter quotes in all series of an option, nor requires that a market maker continue quoting any particular class or series for any length of time. The Commission should require BOX to clarify the obligations of market makers to provide liquidity to assure that BOX market makers would be undertaking a meaningful obligation to provide continuous two-sided markets. This is necessary if BOX participants receive the benefits of being a "market maker" under the Federal Securities Laws. As proposed, market makers may trade in up to 20 percent of the series in their appointed options without maintaining any bids or offers in those series. There are no restrictions with respect to which series the market makers may choose to quote, nor any limits on the percentage of the market maker's volume that can be executed in series it is not quoting. We do not believe that these are sufficiently meaningful obligations to justify a BOX participant receiving market maker status.

The Commission also should give careful consideration to how the BOX market operates when there are no quotes in a series, as this possibility does not exist on any of the current registered options exchanges. For example, how will market orders be handled? How is the execution of orders in the market opening process affected when there are no market maker quotes? How does PIP work when there are no bids or offers in the series? How will an OFP ever satisfy its duty of best execution if it routes orders to BOX in series that have no bids or offers?

## 12. Market Maker Trading Requirements.

Chapter VI, Section 4(e) permits market makers to trade outside their appointed options. However, if a market maker trades more contracts outside its appointment than within "said Market Maker shall pay to BOX a per contract surcharge, which shall be set

by the Board." Compare this to ISE Rule 805(b) and the rules of the other options exchanges, which provide specific limitations on market maker dealings outside their assigned options. The ability to effect market maker transactions in options classes to which a market maker is not appointed is limited, as the market maker does not have the same affirmative obligations in these options classes. This proposed BOX rule appears to permit BOX members to "buy" market maker status in their non-appointed options classes. Failing to meet the requirement does not appear to be a rule violation, and if it were, the imposition of a summary "surcharge" would violate the due process requirements of Section 6 of the Exchange Act. There would be significant implications if exchange participants were allowed to purchase market maker status under, among other things, the margin requirements under Regulation T of the Board of Governors of the Federal Reserve System and the net capital rule (Rule 15c3-1 under the Exchange Act).