

January 19, 2006

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

Re: File No. SR-BSE-2005-52

Dear Ms. Morris:

The International Securities Exchange, Inc. ("ISE") appreciates the opportunity to comment on a recent proposal ("Proposal") of the Boston Stock Exchange, Inc. ("BSE"), on behalf of its Boston Options Exchange ("BOX") facility, to eliminate the anonymity feature of its "directed order" process. We believe that maintaining anonymity in electronic trading systems is critically important: to prevent discrimination; to maintain the integrity of automated trading systems; and, generally, to protect investors. Thus, we urge the Commission to institute proceedings to disapprove the Proposal.

Background to the Proposal

BOX's "Price Improvement Period" ("PIP") permits a BOX member to guarantee an order a price better than the national best bid and offer ("NBBO"). Specifically, when a member enters an order into the PIP, the member guarantees price improvement of at least a penny, and BOX exposes the order in a three-second auction. The order then receives the best price that results from the auction.

The directed order process complements the PIP. Rather than enter an order into the PIP itself (and thus guarantee price improvement), a BOX member can "direct" an order to a BOX market maker that accepts directed orders. Upon receipt of the order, the directed market maker either enters the order into the PIP for price improvement or returns the order to the BOX auction. If the market maker returns the order to the auction, the market maker has last priority in ultimately filling the order. Members who use directed orders generally are firms that do not have their own proprietary trading operations. Thus, rather than trade against their own orders, they direct their orders to market makers with whom they have established order flow arrangements.

Until recently, it was our understanding that BOX market makers did not know the identity of the firms that directed orders to them. Indeed, the BOX rules provide that the "identity of Options Participants who submit orders to the Trading Host will remain anonymous to market participants at all times except [during error resolution or

clearing]."¹ Despite the clear requirements of its own rules, BOX has been providing market makers with the identity of the firms directing orders to them. The purpose of BOX's Proposal thus is to conform BOX's rules to the actual operation of the system.

Because BOX historically has disclosed the identity of the order-entry firms, while the ISE did not, our joint members have found the BOX directed order process more attractive than ours, and we have been at a significant competitive advantage. It was only recently, in reaction to the revelation that BOX disclosed firm identity, that we added the same functionality to our system.²

The Proposal Will Foster Unfair Discrimination

The Securities Exchange Act of 1934 (the "Act") requires that the rules of a national securities exchange, among other things, not be "designed to permit unfair discrimination between customers, issuers, brokers, or dealers...."³ Notwithstanding this requirement, BOX explicitly states that the purpose of the Proposal is to "allow Options Participants to make better informed decisions in determining when and how to use the Directed Order process." Thus, BOX acknowledges that the purpose of disclosing identities is to allow a directed market maker to discriminate between orders for which it will or will not guarantee price improvement based upon the identity of the entering firm.

We first recognize that there is no requirement under the Act for a firm to provide price improvement for any customers. Thus, BOX is free to establish a price improvement mechanism that gives its members discretion as to when to provide price improvement. However, the Act does impose limits on that discretion. Specifically, any such discretion must be in compliance with the prohibition on "unfair discrimination." In this regard, the Act does not permit an exchange to identify an order-entering firm so that a market maker could vary the execution quality it provides to customer orders.

While all orders delivered to a BOX market maker through the directed order process are public customer orders, market makers may be more willing to provide price improvement to certain broker-dealers' orders, and not to others, based on such factors as: (i) the market maker's perception of the "quality" of the broker-dealers order flow; and (ii) agreements between the market maker and the order flow provider that induce the order flow provider to direct orders to the market maker. Indeed, it would appear that a primary purpose of identifying the order flow provider is to facilitate private payment for order flow arrangements between the order-flow provider and the BOX market maker. We hardly think that encouraging payment-for-order-flow arrangements is justification for this type of discrimination.

We recognize that the Commission has sanctioned certain types of discrimination between classes of orders. However, the ISE does not believe that BOX's proposed discrimination among orders of the same class is "fair" as required by the Act. For example, the Commission has allowed the options exchanges and their members to treat customer and professional orders differently in terms of execution priority. This is because professionals effectively are competitors to market makers, who have obligations to provide liquidity to the market. However, that logic does not apply to the Proposal: BOX proposes allowing market makers to discriminate between customer orders so they can establish order-flow arrangements with particular broker-dealers and can avoid improving prices to firms whose order flow is perceived to be less profitable.

¹ BOX Rules, Chapter V, Section 14(e).

² See Files No. SR-ISE-2005-01 and SR-ISE-2005-02.

³ Exchange Act Section 6(b)(5).

There is no precedent for permitting exchanges or market makers to discriminate against selected customers. Indeed, customers have sued exchanges and market makers alleging discriminatory treatment against them for activity very similar to what BOX proposes.⁴ In *Last Atlantis*, plaintiffs allege that the defendant exchanges identified to market makers – through numbers or color codes – orders of customers engaging in sophisticated trading strategies. So alerted, the market makers then allegedly handled such orders on a manual, rather than automated, basis, thus providing those orders inferior executions. The suit alleges that such activity is fraudulent, violative of the exchanges' own rules, and violative of the Exchange Act. Commission approval of this Proposal would effectively establish legal support of this type of discrimination, shielding exchanges and market makers from liability.

Identifying the order-flow provider to the market makers not only gives the market maker inappropriate information when determining whether to give the order price improvement, but it also gives the market maker an inappropriate advantage in the ensuring PIP auction. When the market maker enters the order into the PIP, that market maker – and that market maker alone – knows the identity of the firm entering the order. That market maker then can use such information when determining how much to improve the customer's price. Thus, the Proposal also discriminates against the other BOX members participating in the auction.

The Proposal also undermines the integrity of the exchange-trading process. For our markets to work efficiently, investors must have confidence that brokers, market makers, exchanges and regulators are treating them fairly. The Commission's formal sanctioning of a system that allows market makers to discriminate among customers simply because they have chosen to use a particular broker-dealer will undermine that confidence and will foster the creation of a market rife with discrimination, much like the market questioned in *Last Atlantis*. Investors will not have confidence that their orders will compete for the best price in the market place on a level playing field. Rather, some orders will be subject to regulatorily-sanctioned discrimination simply due to the broker they have chosen.

Also with respect to market integrity, anonymity dovetails with exchange rules that erect informational barriers between market making and order flow operations. Both ISE and BOX have Commission-approved rules that maintain strict separation of these functions.⁵ The purpose of those rules is to ensure the integrity of the marketplace by providing market participants confidence that firms execute all orders fairly, and do not provide preferential treatment to their own order flow. The exact same logic dictates that market makers not provide preferential treatment to directed orders of selected firms.

Approval of the Proposal Would Have Wide-Ranging, Negative Consequences

Commission approval of the Proposal would have wide-ranging negative effects. As discussed above, the Proposal will empower broker-dealers with perceived "good" order flow to bargain for special treatment for their customer orders, which will competitively disadvantage those firms with perceived "bad" order flow. It also will foster payment for order flow. In addition, it will force other options exchanges to abandon anonymity in various respects in order to remain competitive with BOX. While we oppose disclosing the identity of firms entering directed orders, we must remain competitive in the market. As noted, to protect our interests in the event that the

⁴ See *Last Atlantis, et al v. Chicago Board Options Exchange, Inc., et al*, 04cv397 (ND Ill.) ("Last Atlantis").

⁵ ISE Rule 810; Chapter VI, Section 5(b) of BOX's Rules.

Commission approves BOX's Proposal, we have filed rule changes with the Commission to remove the anonymity feature from our directed order process.

The competitive issue is broader than just directed orders. The BOX's directed orders and PIP functionality was introduced to compete with the various execution services offered by the other options exchanges. Thus, in addition to directed orders, there are a number of other services with respect to which we currently disclose order information to our market, but withhold the identity of the entering firm, including the Facilitation Mechanism, our Price Improvement Mechanism auction, and orders that our Primary Market Makers must address when the ISE is not at the BBO. In order to assure our continued competitiveness, it may be necessary to disclose broker identity in these services, too. If the SEC finds that the disclosure of broker-dealer identities is "fair" under the Act with respect to directed orders, we see no logical or legal basis to deny the ISE the ability to disclose the entering firm in these other services.

Finally, if the Commission were to approve the Proposal, we would expect other exchanges to submit similar rule changes removing anonymity from their systems, such as sanctioning the alleged activity that is described in *Last Atlantis*. The wide-scale removal of anonymity and regulatorily-sanctioned discrimination will only exacerbate the harm of BOX's Proposal.

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We urge the Commission to commence proceedings to disapprove the Proposal. We thank the Commission for the opportunity to comment on the Proposal, and we are available to discuss this issue with either the Commission or its staff if you would find that useful.

Sincerely,



Michael J. Simon
Secretary

cc: Robert Colby
Elizabeth King