provided, as well as on the costs for the physical installations of equipment.

IV. Conclusion

It is therefore ordered, pursuant to section 19(b)(2) of the Act [15] that the proposed rule change (File No. SR–BSE–2003–17) is hereby approved and the portion of the proposed rule change relating to linkage fees is approved on a pilot basis until January 31, 2004.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 04–1116 Filed 1–16–04; 8:45 am]

BILLING CODE 8010–01–P

[15] 15 U.S.C. 78s(b)(2).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–49068; File No. SR–BSE–2002–15]

Self Regulatory Organizations; Order Granting Approval to Proposed Rule Change and Amendment No. 3 and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 4 Thereto by the Boston Stock Exchange, Inc. Establishing Trading Rules for the Boston Options Exchange Facility

January 13, 2004.

I. Introduction

On October 31, 2002, the Boston Stock Exchange, Inc. (''BSE'' or ''Exchange''), submitted to the Securities and Exchange Commission (''Commission'' or ''SEC''), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 thereunder,[2] a proposed rule change to establish trading rules for the proposed Boston Options Exchange (''BOX'') [3] facility. On December 18, 2002, the BSE filed Amendment No. 1 that entirely replaced the original rule filing.[4] On January 9, 2003, the BSE filed Amendment No. 2 that entirely replaced the original rule filing and Amendment No. 1.[5] Amendment No. 2 was published in the **Federal Register** on January 22, 2003 (''BOX Proposing Release'').[6]

The Commission received 43 comment letters in response to the January 22, 2003, notice.[7]

In response to the comment letters, the BSE filed Amendment No. 3 to the proposal.[8] The proposed changes were published for comment in the **Federal Register** on August 22, 2003.[9] The Commission received 301 comment letters in response to Amendment No. 3.[10] In response to the comment letters,

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] The term ''BOX'' means the Boston Options Exchange or Boston Stock Exchange Options Exchange, an options trading facility of the Exchange under section 3(a)(2) of the Act. *See* proposed BOX Rules, Chapter I, sec. 1(a)(6) (definition of ''BOX'').

[4] *See* letter from George W. Mann, Jr., Executive Vice President and General Counsel, BSE, to Annette Nazareth, Director, Division of Market Regulation (''Division''), Commission, dated December 18, 2002 (''Amendment No. 1'').

[5] *See* letter from George W. Mann, Jr., Executive Vice President and General Counsel, BSE, to Annette Nazareth, Director, Division, Commission, dated January 8, 2003 (''Amendment No. 2'').

[6] Securities Exchange Act Release No. 47186 (January 14, 2003), 68 FR 3062 (January 22, 2003).

[7] *See* letters to Jonathan G. Katz, Secretary, Commission, from Paul Fred, CEO, PFTC Trading, LLC, dated January 24, 2003; Myron Wood, Statistician, Changes, LLC, dated January 30, 2003; Mike Ianni, dated February 2, 2003; Shawn Gibson, Senior VP, Equity Derivatives, Scott & Stringfellow, dated February 6, 2003; CSFB Next Fund, Inc., Interactive Brokers Group, LLC, LabMorgan Corporation, Salomon Brothers Holding Company, Inc., UBS (USA) Inc., dated February 6, 2003; Sallerson-Troob, LLC, dated February 9, 2003; Christopher D. Bernard, dated February 10, 2003; George Papa, Director, PEAK6 Investments, dated February 10, 2003; Frank Hirsch, CBOE Market Maker, dated February 10, 2003; Richard W. Cusack, Operations Manager, Sparta Group of Chicago, LP, dated February 11, 2003; Paul Britton, CEO, MAKO Global Derivatives LLC, dated February 11, 2003; John Colletti, Samuelson Trading, dated February 11, 2003; Robert S. Smith, Chief Technology Officer, GETCO, LLC, dated February 11, 2003; Phillip Sylvester, CBOE Market Maker, dated February 11, 2003; Keith Fishe, DRW Holdings, LLC, dated February 11, 2003; Daniel C. Bigelow, President, Monadnock Capital Management, dated February 11, 2003; Erich Tengelsen, Chicago Trading Company, dated February 12, 2003; Thomas Peterffy, Chairman, David M. Battan, Vice President and General Counsel, Interactive Brokers LLC, dated February 12, 2003; John T. Thomas, Van Der Moolen USA LLC, dated February 12, 2003; Robert C. Sheehan, Electronic Brokerage Systems LLC, dated February 12, 2003; Thomas J. Murphy, TJM Investments, LLC, dated February 12, 2003; Meyer S. Frucher, Chairman and Chief Executive Officer, Philadelphia Stock Exchange, Inc. (''Phlx''), dated February 12, 2003 (''Phlx Letter 1''); Michael Resch, dated February 12, 2003; Todd Silverberg, General Counsel, Susquehanna International Group LLP, dated February 12, 2003; Michael J. Simon, Senior Vice President and Secretary, International Securities Exchange, Inc. (''ISE''), dated February 12, 2003 (''ISE Letter 1''); Juan Carlos Pinilla, Managing Director, Equity Derivatives Trading, JP Morgan, dated February 12, 2003; Marc J. Liu, Options Specialist, AGS Specialist Partners, dated February 12, 2003; Jan-Joris Hoefnagel, President, Optiver Derivatives Trading, dated February 13, 2003; Steve Tumen, CEO, and David Barclay, General Counsel, Equitec Group, LLC, dated February 14, 2003; Michael J. Ryan, Jr., Executive Vice President & General Counsel, American Stock Exchange LLC (''Amex''), dated February 14, 2003 (''Amex Letter 1''); William J. Brodsky, Chairman and Chief Executive Officer, Chicago Board Options Exchange, Inc. (''CBOE''), dated February 14, 2003 (''CBOE Letter 1''); Paul Roesler, Lead Market Maker, Pacific Exchange, Inc. (''PCX''), dated February 14, 2003; Andrew W. Lo, dated February 15, 2003; Nicholas Bonn, Executive Vice President, State Street Global Markets, LLC, dated February 21, 2003; Robert Bellick, Christopher Gust, Wolverine Trading, LLC, dated February 27, 2003; Philip D. DeFeo, Chairman and CEO, PCX, dated February 27, 2003 (''PCX Letter 1''); Thomas N. McManus, Executive Director and Counsel, Morgan Stanley, dated March 3, 2003; Philip C. Smith, Jr., Vice President, Options, The Interstate Group, dated March 7, 2003; Bryan Rule, dated March 11, 2003; Michael J. Ryan, Jr., Executive Vice President & General Counsel, Amex, dated March 13, 2003 (''Amex Letter 2''); David Hultman, dated March 25, 2003; Stephen D. Barret, dated March 26, 2003; and John Welker, dated June 11, 2003.

[8] *See* letter from George W. Mann, Jr., Executive Vice President and General Counsel, BSE, to Annette Nazareth, Director, Division, Commission, dated August 15, 2003 (''Amendment No. 3'').

[9] Securities Exchange Act Release No. 48355 (August 15, 2003), 68 FR 50813 (August 22, 2003) (''Amendment No. 3 Notice'').

[10] *See* letters to Jonathan G. Katz, Secretary, Commission, from R.J. Casey, dated September 2, 2003; Gary Sutton, dated September 2, 2003; Dr. Jay Charles Soper, dated September 2, 2003; Darshan Arora, dated September 2, 2003; Carl Erikson, dated September 2, 2003; Dwayne Logie, dated September 2, 2003; David B. Pincus, dated September 2, 2003; Dmitri Gerasimenko, dated September 2, 2003; Dr. Gary T. Hirst, Chairman, Hirst Investment Management Inc., dated September 2, 2003; Doug Brunner, dated September 2, 2003; David Richardson, dated September 2, 2003; Eddie Wan, dated September 2, 2003; Donald Tolchin, dated September 2, 2003; Austin B. Tucker, dated September 2, 2003; Ilya Dorfman, dated September 2, 2003; Carey Pierce, dated September 2, 2003; David Maple, dated September 2, 2003; Gregory Cone, dated September 2, 2003; Byron Sears, dated September 2, 2003; Chad B. Harris, Managing Director, Sharp People Scottsdale, dated September 2, 2003; Clint Rasschaert, dated September 2, 2003; Michael Burgess, dated September 2, 2003; Edward C. Spengler II, dated September 2, 2003; Basilio Chen, dated September 2, 2003; Sam Wheat, dated September 2, 2003; Wie-Ming Ang, dated September 2, 2003; Douglas A. DeMoss, dated September 2, 2003; Karl Aschenbrenner, dated September 2, 2003; C.E. Sherrod, dated September 2, 2003; Alan Johnson, dated September 2, 2003; John Mazur, dated September 2, 2003; Skyler Christensen, dated September 2, 2003; Rachel Fitz, dated September 2, 2003; Billb Billb, dated September 2, 2003; Damodharan Ramkumar, dated September 3, 2003; Jim McNeil, dated September 3, 2003; Dr. Donald R. Berger, dated September 3, 2003; Scott Alber, dated September 3, 2003; Eric Glasband, dated September 3, 2003; Frank Sandy, dated September 3, 2003; Mu Chou Liu, ITresources, dated September 3, 2003; Vernon Hehn, dated September 3, 2003; Anthony J. Benincasa, dated September 3, 2003; Gregg Richter, dated September 3, 2003; L. Jerry L. Jones, dated September 3, 2003; Francis Borriello, dated September 3, 2003; David D. Smith, dated September 3, 2003; Robert H. Dean, dated September 3, 2003; Joseph Szoecs, dated September 3, 2003; E. Eimas, dated September 3, 2003; Curtis G. Thompson, Black Swan Trading, dated September 3, 2003; Tom Harney, dated September 3, 2003; Jim Schmechel, dated September 3, 2003; Tom Fisher, dated September 3, 2003; Andrew Eisenhawer, dated September 3, 2003; David Nemes, dated September 3, 2003; Leland Stevenson, dated September 3, 2003; David Strauss, dated September 3, 2003; Jim Engelken, dated September 3, 2003; Jim Woo, dated September 3, 2003; Marc Poussard, Bae Systems, dated September 3, 2003; William W. Williams, dated September 3, 2003; Steve Sundberg, Software Engineer, General Dynamics Land Systems, dated September 3, 2003; Fang Gu, dated September 3, 2003; Stanley Arron, dated September 3, 2003; Matti Luomanen, dated September 3, 2003; Robert Jinks, dated September 3, 2003; Daniel Torres, dated September 3, 2003; Michael Vilkin, dated September 3, 2003; Harvey Carmel, dated September 3, 2003; Barry Wolfe,

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dated September 3, 2003; Zhenyu Yang, dated September 3, 2003; John Jagerson, CNBCU Personal Trainer, dated September 3, 2003; Roark Janis, dated September 3, 2003; Barry R. Schotz, dated September 3, 2003; Peter Reese, dated September 3, 2003; Chadwick McHugh, dated September 3, 2003; Ray Crews, dated September 3, 2003; Kevin Bates, dated September 3, 2003; Vineet Jain, dated September 3, 2003; Steven K. Gross, Penso Capital Markets, LLC, dated September 3, 2003; Jeffrey S. Hauge, dated September 3, 2003; Harry I. Brown, Jr., dated September 3, 2003; Sai Rao, dated September 3, 2003; J. Mentesseg, dated September 3, 2003; Arthur E. Blossom, dated September 3, 2003; Michael Selbs, dated September 3, 2003; Jeff Schanker, dated September 3, 2003; L.W. Kramer, dated September 3, 2003; William J. Sheppard, dated September 3, 2003; Paul Levin, dated September 3, 2003; André L. Morissette, dated September 3, 2003; Shuowen Yang, dated September 3, 2003; Steve Kragen, dated September 3, 2003; Richard Berry, dated September 3, 2003; Bob Palfreeman, dated September 3, 2003; Anthony P. Matthews, dated September 3, 2003; Zoran Djokic, dated September 3, 2003; Mark Williamson, dated September 3, 2003; Yul Lipner, dated September 3, 2003; Charles Thompson, dated September 3, 2003; Peter Gum, dated September 3, 2003; Harvey Lichterman, dated September 4, 2003; Ronald Scott, dated September 3, 2003; Libero Greco, dated September 3, 2003; Ralph Berry, dated September 3, 2003; Philip Tonne, dated September 3, 2003; Bruce, dated September 3, 2003; David E. Banks, September 3, 2003; Eli Y. Khoury, dated September 3, 2003; Lawrence Soh, dated September 3, 2003; John Davidson, dated September 3, 2003; Paul Feingold, dated September 3, 2003; Matt Kubitsky, dated September 3, 2003; Jesse Principato, dated September 3, 2003; Peter Ritter, dated September 3, 2003; Ron Young, dated September 3, 2003; Peter Zetlin, dated September 3, 2003; Peter Zwag, dated September 3, 2003; Daniel Fitzpatrick, dated September 3, 2003; Rick Westerfield, dated September 3, 2003; Gary Kemp, dated September 3, 2003; Larry Pinkus, dated September 3, 2003; Joel Reingold, dated September 3, 2003; Harald Kempf, dated September 3, 2003; Domenico Ciampa, dated September 3, 2003; Wenhao Li, dated September 3, 2003; Doug Layton, dated September 3, 2003; Jack Scholze, dated September 3, 2003; Doug Churchill, dated September 3, 2003; Bobby Emory, dated September 3, 2003; Richard Phillips, dated September 3, 2003; Bernhard Abmayr, dated September 3, 2003; Gene Liang, dated September 3, 2003; Dvir Langer, dated September 3, 2003; Chin Chin Tan, dated September 3, 2003; James F. Kelly, dated September 3, 2003; Charles M. Steiner, dated September 3, 2003; Joseph Grodsky, dated September 3, 2003; Aaron Zalewski, dated September 3, 2003; Jay Texan, dated September 3, 2003; Mark Rubensohn, dated September 3, 2003; Charles LaPointe, dated September 3, 2003; Martin Rosenblatt, dated September 3, 2003; Dr. Günther Hofbauer, dated September 3, 2003; Dean Huang, dated September 4, 2003; Roger Britton, dated September 4, 2003; N. Kaiser, dated September 4, 2003; Roger Easton, dated September 4, 2003; Kirk Cooley, dated September 4, 2003; Venkatesh Janakiraman, dated September 4, 2003; John Welker, September 4, 2003; David Johnston, Mercury Advertising, dated September 4, 2003; Wayne LaFlamboy, dated September 4, 2003; Joe Milliner, dated September 4, 2003; Ken Peek, dated September 4, 2003; Ron Bliss, dated September 4, 2003; Rong Lin, dated September 4, 2003; Ted Kreuser, dated September 4, 2003; Randy G. Malm, dated September 4, 2003; Jeff Levitt, Director of Research, Stanton Chase International, dated September 4, 2003; Ron Baakkonen, Manager, Electronic Trading & Retail Flow, PEAK6 Investments, LP, dated September 4, 2003; Wayne Chang, dated September 4, 2003; Jerome Ablon, dated September 5, 2003; Tim Crowley, dated September 5, 2003; Eugen, dated September 5, 2003; Paul Fred, CEO PFTC Trading LLC, dated September 5, 2003; Phillip J. Sylvester, dated September 5, 2003; Wilbur Su, dated September 6, 2003; Mike Rouzer, dated September 6, 2003; Bryant Otter, dated September 6, 2003; William Christie, dated September 6, 2003; Spencer Ball, dated September 6, 2003; Neil Lulla, dated September 7, 2003; John Doe, dated September 7, 2003; Mo Soysa, dated September 7, 2003; Grady G. Thomas, Jr., President, The Interstate Group, Division of Morgan Keegan & Co., Inc., dated September 8, 2003; Don Bayne, dated September 8, 2003; Rolf van der Klink, dated September 8, 2003; Andrew W. Lo, dated September 9, 2003; Richard Hallas, dated September 9, 2003; Michael Bock, dated September 9, 2003; Nicholas J. Bonn, Executive Vice President and CFO, State Street Global Markets, LLC, dated September 10, 2003; Stephen D. Barrett, Wainwright Financial Services, dated September 10, 2003; Miguel Ladios, dated September 10, 2003; Stephen Kaelber, dated September 10, 2003; Paul Britton, CEO, MAKO Global Derivatives, LLC, dated September 10, 2003; Simon Lubershane, dated September 10, 2003; Chris Cobb, dated September 10, 2003; Steven Quirk, Saen Options, dated September 10, 2003; Donald W. Pendergast, Jr., dated September 10, 2003; Todd Silverberg, General Counsel, Susquehanna International Group, LLP, dated September 11, 2003; Todd Batiste, dated September 11, 2003; Diane Dowling, dated September 11, 2003; John Colin Jones, dated September 11, 2003; Kenneth M. King, President, K & S Inc., Member Boston Stock Exchange, dated September 11, 2003; John Keazirian, Executive Vice President, Rho Trading Securities, LLC, dated September 11, 2003; Robert E. Shultz, dated September 11, 2003; Simon Yates, Managing Director, Credit Suisse First Boston, dated September 11, 2003; Michael J. Ryan, Jr., Executive Vice President and General Counsel, Amex, dated September 12, 2003 (''Amex Letter 3''); David Weisberger, Managing Director, Citigroup Global Markets Inc., dated September 12, 2003; Meyer S. Frucher, Chairman and Chief Executive Officer, Phlx, dated September 12, 2003 (''Phlx Letter 2''); William Bartlett, Parallax Fund, LP, dated September 12, 2003; Yomo Guiamo, dated September 12, 2003; Mike Ianni, dated September 12, 2003; Dennis Michiels, dated September 12, 2003; Linda M. Sarkisian, President, Sarkisian Securities, dated September 12, 2003; Robert C. Sheehan, Chairman, Electronic Brokerage Systems, LLC, dated September 12, 2003; Michael J. Simon, Senior Vice President and General Counsel, ISE, dated September 12, 2003 (''ISE Letter 2''); Eric Tripp, President, BMO Nesbitt Burns Securities Limited, dated September 12, 2003; Joseph Lombardi, dated September 13, 2003; Mano Appapillai, dated September 14, 2003; Derek Mahar, dated September 14, 2003; Philip D. DeFeo, Chairman and Chief Executive Officer, PCX, dated September 15, 2003 (''PCX Letter 2''); Harvey Bernstein, dated September 15, 2003; Harilaos Mantzoros, Xenos Trading, dated September 15, 2003; Thomas Peterffy, Chairman, Interactive Brokers Group, LLC, dated September 16, 2003; William J. Brodsky, Chairman and Chief Executive Officer, CBOE, dated September 16, 2003 (''CBOE Letter 2''); Andrew Henry, Managing Member, Henry Capital Management, LLC, dated September 16, 2003; Bastiaan van Kempen, Director, Optiver US, LLC, dated September 16, 2003; Steve Verbos, dated September 17, 2003; Craig Hancey, dated September 18, 2003; Allison Brandsma, dated September 19, 2003; Fabrizio J. Fili, dated September 20, 2003; Ralph Winters, dated September 21, 2003; Mary McDermott-Holland, Senior Vice President, Franklin Portfolio Associates, dated September 23, 2003; Lewis P. Dickey, General Partner, Options Unlimited, dated September 24, 2003; James C. Miller III, Chairman, The CapAnalysis Group, LLC, dated September 26, 2003; H. Kaur, dated October 17, 2003; Jeff Sutton, dated December 14, 2003; and Michael J. Simon, Senior Vice President and General Counsel, ISE, dated December 16, 2003 (''ISE Letter 3'').

on January 9, 2004, the BSE filed Amendment No. 4 to the proposed rule change, and a written response to comment letters.[11]

This order approves the BSE's proposed rule change, as amended, publishes notice of Amendment No. 4 to the proposed rule change, and grants accelerated approval to Amendment No. 4.

II. Discussion

After careful review of the proposal and consideration of the comment letters, the Commission finds that the proposed rule change to establish trading rules for the BOX facility is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange and, in particular, the requirements of section 6 of the Act.[12] Specifically, the Commission finds that the proposal is consistent with section 6(b)(5) of the Act,[13] which requires, in part, that the rules of an exchange be designed to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to foster cooperation and coordination with persons engaged in regulating, clearing, settling, and processing information with respect to, and facilitating transactions in securities; to remove impediments to and perfect the mechanism of a free and open market and a national market system; and, in general, to protect investors and the public interest. Section 6(b)(5) also requires that the rules of an exchange not be designed to permit unfair discrimination among customers, issuers, brokers, or dealers.

Overall, the Commission believes that approving the BSE's proposal to establish trading rules for the BOX facility should confer important benefits to the public and provide U.S. market participants with a new market in which to trade standardized options. As a fully electronic options market with relatively lower barriers to access,[14]

[11] *See* letter from George W. Mann, Jr., Executive Vice President and General Counsel, BSE, to Annette Nazareth, Director, Division, Commission, dated January 9, 2004 (''Amendment No. 4''). As discussed below, in Amendment No. 4, the BSE proposes to clarify its rules to address issues raised by commenters, and to make other technical, non-material changes. *See also* letter from George W. Mann, Executive Vice President and General Counsel, BSE, to Jonathan G. Katz, Secretary, Commission, dated Janaury 9, 2004.

[12] 15 U.S.C. 78f.

[13] 15 U.S.C. 78f(b)(5).

[14] *See* Securities Exchange Act Release No. 49066 (January 13, 2004) (SR–BSE–2003–17) (Order approving BOX fee schedule (''BOX Fee Approval'')).

BOX's entry into the options marketplace may potentially reduce the costs of trading to investors and market professionals, enhance innovation, and increase competition between and among the options exchanges, resulting in better prices and executions for investors. In addition, the BSE has committed to develop and maintain an appropriate system of surveillance and an audit trail.[15]

This discussion does not review every rule and representation made by the BSE that has been filed as part of its proposed rule change; rather, it focuses on the most prominent rules and policy issues considered in review of the BSE's proposal.

A. BOX Is an Options Trading Facility of the BSE

The BSE proposes to establish BOX as an options trading facility of the BSE, a registered national securities exchange. BOX would be operated by Boston Options Exchange Group LLC (''BOX LLC''). One commenter objects to the characterization of BOX as a ''facility'' of the BSE and asserts that the Commission should require BOX to file an application to register as a national securities exchange under section 6 of the Act.[16]

The Commission believes that the BSE's proposal to establish BOX as its facility [17] is properly filed under section 19(b)(1) of the Act,[18] and that it is not necessary for BOX to register as a national securities exchange independent of the BSE under section 6(a) of the Act.[19] Section 19(b)(1) of the Act requires that every self-regulatory organization (''SRO'') file with the Commission copies of any proposed rule or any proposed change to its rules, accompanied by a concise general statement of the basis and purpose of the proposed rule change. The Commission is required to publish notice of the filing of a proposed rule change and to give interested persons an opportunity to submit written data, views, and arguments. Section 19(b)(2) of the Act [20] provides that the Commission shall approve an SRO's proposed rule change if it is consistent with the requirements of the Act and the rules and regulations thereunder applicable to the SRO, or disapprove the proposed rule change if the Commission does not make such a finding. In the Commission's view, the BSE's proposal to establish BOX as an exchange facility is consistent with the Act, as well as with previous proposals of national securities exchanges filed under section 19(b) of the Act [21] to use the personnel and equipment of third parties to operate trading platforms.[22]

In addition, the Commission believes that the proposal discussed herein has provided sufficiently detailed information about the trading rules of BOX and that the public has had ample opportunity to comment on the proposal. The BSE proposal was originally published for comment in January 2003 and an amended proposal was published for further comment in August 2003. In the many months that the proposal has been in the public domain, interested persons, including other SROs, broker-dealers, investors, and other market participants have submitted comments on the proposal.

A couple of commenters request that BOX disclose fully the relationship of the founding members and investors of BOX LLC, including their role in the market and governance, and agreements between and among the members and investors or other parties providing critical services to BOX.[23] The Commission notes that the BSE filed separate proposed rule changes addressing these matters, all of which were published for comment.[24]

The Commission further notes that, as a registered exchange, the BSE is required to file an amendment to its Form 1 to reflect the agreements relating to the operation of BOX and BOXR, including a description of its affiliations with other parties, information describing the reporting, clearance, or settlement of transactions in connection with the operation of the facility, and a copy of existing by-laws or corresponding rules and instruments.[25]

B. BOX Market Structure Generally

1. BOX Options Participants

Unlike the existing options exchanges, which have a specialist or primary market maker driven system, BOX would have only one category of members, known as ''Options Participants.'' [26] Only Options Participants would be permitted to transact business on BOX via the BOX Trading Host.[27] The BSE would authorize any Options Participant who meets certain enumerated qualification requirements to obtain access to BOX.[28] An Order Flow Provider (''OFP'') may transact business with Public Customers only if it is a member of another national securities exchange or association with which the BSE has entered into an agreement under Rule 17d–2 [29] of the Act.[30]

Among other things, Options Participants must be registered as broker-dealers pursuant to the Act and have as the principal purpose of being an Options Participant the conduct of a securities business.[31] Such a purpose would be deemed to exist if and as long as: (1) The Options Participant has qualified and acts in respect of its business on BOX as either an OFP or a Market Maker, or both; and (2) all transactions effected by the Options Participant are in compliance with section 11(a) of the Act [32] and the rules and regulations thereunder.[33] Options

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[15] *See* BOX Proposing Release, *supra* note 6.

[16] 15 U.S.C. 78f. *See* CBOE Letter 1, *supra* note 7, at 2–3.

[17] *See* 15 U.S.C. 78c(a)(2) (definition of ''facility'').

[18] 15 U.S.C. 78s(b)(1).

[19] 15 U.S.C. 78f(a).

[20] 15 U.S.C. 78s(b)(2).

[21] 15 U.S.C. 78s(b).

[22] *See, e.g.*, Securities Exchange Act Release No. 41210 (March 24, 1999), 64 FR 15857 (April 1, 1999) (approval of Phlx's VWAP Trading System); Securities Exchange Act Release No. 39086 (September 17, 1997), 62 FR 50036 (September 24, 1997) (approval of PCX's Application of the OptiMark System). *See also* Securities Exchange Act Release No. 41967 (September 30, 1999), 64 FR 54704 (October 7, 1999) (approval of Nasdaq Application of OptiMark System); Securities Exchange Act Release No. 35030 (November 30, 1994), 59 FR 63141 (December 7, 1999) (approval of Chicago Match System); Securities Exchange Act Release No. 44983 (October 25, 2001), 66 FR 55225 (November 1, 2001) (approval of Archipelago Exchange).

[23] *See* CBOE Letter 1, *supra* note 7, at 3; *see* Amex Letter 3, *supra* note 10, at 1.

[24] *See* Securities Exchange Act Release No. 48650 (October 17, 2003), 68 FR 60731 (October 23, 2003) (Notice of BOX LLC Operating Agreement). The Commission approved the BOX LLC Agreement filing today. *See* Securities Exchange Act Release No. 49067 (January 13, 2004). In addition, the Commission today approved a filing relating to the BSE's proposed transfer to a new options regulatory subsidiary, Boston Options Exchange Regulation LLC (''BOXR''), a Delaware limited liability company and a wholly-owned subsidiary of the BSE, all of the assets and liabilities that solely support the regulation of the standardized equity options trading business of the BSE. Upon this transfer, however, the BSE would continue to be the self-regulatory organization for BOXR and BOX. *See* Securities Exchange Act Release No. 49065 (January 13, 2004) (SR–BSE 2003–04) (''BOXR Delegation Plan Approval Order'').

[25] *See* Rule 6a–2 under the Act, 17 CFR 240.6a–2; *see also* Form 1, 17 CFR 249.1.

[26] *See* proposed BOX Rules, Chapter I, sec. 1(a)(40).

[27] *See* proposed BOX Rules, Chapter II, sec. 1(a).

[28] The BSE would not limit the number of qualifying entities that may become Options Participants. However, approval of qualifying applications for Options Participants may be temporarily deferred due to system constraints or capacity restrictions. *See* proposed BOX Rules, Chapter II, sec. 1(d).

[29] 17 CFR 240.17d–2.

[30] *See* proposed BOX Rules, Chapter XI, sec. 1. *See also infra* notes 299–303 and accompanying text for a discussion of Rule 17d–2.

[31] *See* proposed BOX Rules, Chapter II, sec. 2(b), (h); *see also* Amendment No. 4, *supra* note 11.

[32] 15 U.S.C. 78k(a).

[33] *See* proposed BOX Rules, Chapter II, sec. 2(h)(i) and (ii).

Participants may trade options for their own proprietary accounts or, if authorized to do so under applicable law, may conduct business on behalf of Customers.[34]

a. Order Flow Providers

OFPs would be those Options Participants representing Customer Orders [35] as agent on BOX and those non-market maker Participants conducting proprietary trading.[36] OFPs may also register as Market Makers.[37] OFPs may trade as principal, both as contra party to Customer Orders submitted to BOX by such OFP and as contra party to unrelated orders submitted to BOX by other Options Participants.

One commenter expresses concern that BOX's proposal lacks a provision prohibiting an OFP (non-Market Maker) from entering multiple two-sided bids and offers into the system, as principal or agent for the account of the same beneficial owner, in such a manner that the participant or owner is effectively operating as a Market Maker.[38] In Amendment No. 4, BOX responds directly to this concern by proposing a new rule prohibiting an OFP from entering into BOX, as principal or agent, Limit Orders in the same options series, for the account or accounts of the same or related beneficial owners, in such a manner that the OFP or the beneficial owner(s) effectively is operating as a Market Maker by holding itself out as willing to buy and sell such options contract on a regular or continuous basis. In determining whether an OFP or beneficial owner effectively is operating as a Market Maker, BOXR would consider, among other things: Simultaneous or near-simultaneous entry of Limit Orders to buy and sell the same options contract; the acquisition and liquidation of positions in the same options series during the same day; and the entry of Limit Orders at different prices in the same options series.[39] The Commission believes that this provision is consistent with the Act and should help to prevent OFPs from reaping the benefits of market making activities without having any of the concomitant obligations.[40] The Commission also believes that this provision is designed to prevent Customers from acting as unregistered Market Makers.

b. Market Makers

BOX Market Makers are Options Participants registered with the Exchange as Market Makers and approved by BOXR [41] for an appointment in an options class listed on BOX.[42] Registered BOX Market Makers would be designated as specialists on the BSE for all purposes under the Act.[43]

i. Market Maker Qualifications. To become a Market Maker on BOX, an Options Participant is required to register as a BOX Market Maker by filing a written application with BOXR.[44] BOXR will not place any limit on the number of qualifying entities that may become Market Makers.[45]

In addition to registering as a Market Maker, a Market Maker must obtain an appointment in each options class in which it wishes to make a market on BOX. In approving the Market Maker's appointment in a class, BOXR would consider, among other things: (i) The financial and technical resources available to the Market Maker; (ii) the Market Maker's experience, expertise, and past performances in making markets or options trading; and (iii) the maintenance and enhancement of competition among Market Makers in each class of options to which it is appointed.[46]

BOXR may appoint each Market Maker to any options class listed on BOX for trading. Such an appointment would consist of at least one class and may include all classes traded on the Exchange.[47] BOXR would not list an options class for trading unless at least two Market Makers are appointed to the options class.[48] In addition, before BOXR opens trading for any additional series of an options class, it would require at least two Market Makers to be appointed for trading that particular class. Upon appointment, BOXR would require Market Makers to maintain active markets in that class for a period of at least six months.[49]

However, BOXR would not require a Market Maker in a class to continue trading in that class if BOXR makes an affirmative determination that continued trading in that class by a single Market Maker is to the detriment of that Market Maker, of no adverse consequence to an existing Customer of BOX or an Options Participant, and serves no greater purpose in the fair and orderly functioning of the marketplace.[50] BOXR may continue to allow trading in a class opened for trading that subsequently has only one Market Maker appointed, if it makes an affirmative determination that halting of trading in such class would be detrimental to the remaining Market Maker and that continued trading in such class by one Market Maker would be in the interest of maintaining a fair and orderly marketplace and would not create adverse consequences to an existing Customer of BOX or an Options Participant.[51]

BOXR may suspend or terminate any appointment of a Market Maker, make additional appointments, or change the options classes included in a Market Maker's appointment whenever, in BOXR's judgment, the interests of a fair and orderly market are best served by such action.[52]

The Commission finds that the BOX's Market Maker qualification requirements are consistent with the Act, and notes that they are similar to those adopted by other options exchanges.[53]

ii. Market Maker obligations. Market Makers on BOX would be required to electronically engage in a course of dealing for their own account to enhance liquidity available on BOX and

[34] A "Customer" means either a "Public Customer" or a broker-dealer. *See* proposed BOX Rules, Chapter I, sec. 1(a)(19). A "Public Customer" is a person that is not a broker or dealer in securities. *See* proposed BOX Rules, Chapter I, sec. 1(a)(50).

[35] A "Customer Order" means an agency order for the account of either a Public Customer or a broker-dealer. *See* proposed BOX Rules, Chapter I, sec. 1(a)(20).

[36] *See* proposed BOX Rules, Chapter I, sec. 1(a)(46).

[37] BOX Market Makers are Options Participants registered with the Exchange as Market Makers and approved by BOX Regulation ("BOXR") for an appointment in an options class listed on BOX. *See* proposed BOX Rules, Chapter VI, sec. 4(a).

[38] *See* PCX Letter 2, *supra note* 10, at Appendix at 12.

[39] *See* proposed BOX Rules, Chapter V, sec. 17; *see also* Amendment No. 4, *supra note* 11.

[40] *See* proposed BOX Rules, Chapter VI, sec. 5.

[41] As discussed above, BOXR is a wholly-owned subsidiary of the Exchange. *See* BOXR Delegation Plan Approval Order, *supra* note .

[42] *See* proposed BOX Rules, Chapter VI, sec. 4(a). Subject to certain limitations, a Market Maker may enter all order types permitted to be entered by Customers under the BOX Rules to buy or sell options in classes of options listed on BOX to which the Market Maker is not appointed. *See* proposed BOX Rules, Chapter VI, sec. 6(e).

[43] *See* proposed BOX Rules Chapter I, sec. 1(a)(32) and Chapter VI, sec. 1.

[44] *See* proposed BOX Rules, Chapter VI, sec. 1(a).

[45] However, as noted above, *supra* note 28, based on system constraints, capacity restrictions or other factors relevant to protecting the integrity of the BOX Trading Host, BOXR may limit access to the Trading Host for a period to be determined in its discretion. *See* proposed BOX Rules, Chapter VI, sec. 1(c). The BSE would submit any such limitation on access to the BOX Trading Host as a proposed rule change to the Commission for approval pursuant to section 19(b) of the Act. 15 U.S.C. 78s(b).

[46] *See* proposed BOX Rules, Chapter VI, sec. 4(b).

[47] *See* proposed BOX Rules, Chapter VI, sec. 4(a).

[48] *See* proposed BOX Rules, Chapter IV, sec. 5(a).

[49] *See* proposed BOX Rules, Chapter VI, sec. 5(a)(viii).

[50] *See* proposed BOX Rules, Chapter IV, sec. 5(b).

[51] *See* proposed BOX Rules, Chapter IV, sec. 5(c).

[52] *See* proposed BOX Rules, Chapter VI, sec. 4(c).

[53] *See, e.g.,* CBOE Rule 8.3(a); ISE Rule 802(a).

to assist in the maintenance of fair and orderly markets.[54] Among other things, Market Makers would have to satisfy the following responsibilities and duties during trading: (i) Maintain a two-sided market for at least 10 contracts [55] in at least eighty percent (80%) of the options series, for at least ninety percent (90%) of the classes to which the Market Maker is assigned, provided that a Market Maker is quoting at all times in at least sixty percent (60%) of the options series of any class to which the Market Maker is appointed; [56] (ii) participate in the opening; [57] (iii) maintain minimum net capital in accordance with SEC and BOX Rules; [58] and (iv) within three seconds of receiving any Request for Quote (''RFQ''), post or maintain for at least 30 seconds, a valid two-sided quote in a series in a class to which it is appointed.[59] If BOXR found any substantial or continued failure by a Market Maker to meet any of its obligations and duties, BOXR would subject the Market Maker to disciplinary action, suspension, or revocation of the Market Maker's appointment in one or more options classes.[60]

Market Makers receive certain benefits for carrying out their duties. For example, a lender may extend credit to a broker-dealer without regard to the restrictions in Regulation T of the Board of Governors of the Federal Reserve System if the credit is to be used to finance the broker-dealer's activities as a specialist or market maker on a national securities exchange.[61] The Commission believes that a Market Maker must have an affirmative obligation to hold itself out as willing to buy and sell options for its own account on a regular or continuous basis to justify this favorable treatment. In this regard, the Commission believes that BOX's rules are consistent with the Act, as they impose such affirmative obligations on BOX Market Makers.

One commenter states that the quoting obligations of Market Makers were vague in that there could be no quote in the BOX market for an extended period of time.[62] The Commission agrees that under the BSE's proposal certain series may not have continuous quotes disseminated by BOX. Nevertheless, because the definition of ''market maker'' includes a dealer who holds himself out as being willing to buy and sell a security for his account on a regular or continuous basis,[63] the Commission believes that the obligations imposed by the BOX Rules on Market Makers are consistent with the Act. The Commission also notes that the CBOE Hybrid trading system has market maker obligations comparable to those proposed for BOX and also does not require market makers to quote all series.[64]

2. The BOX Central Order Book (''BOX Book'')

a. Types of Orders

There are three types of orders that may be submitted to the BOX Trading Host: a Limit Order, a Box-Top Order, and a Market-on-Opening Order.[65] Where no order type is specified, the BOX Trading Host will reject the order. In addition, there are several specific designations that can be added to Limit Orders or BOX-Top Orders.[66]

i. Order Types. Limit Orders entered into the BOX Book are executed at the stated limit price or better. Any residual volume left after part of a Limit Order has traded is retained in the BOX Book until it is withdrawn or traded (unless a specific designation is added which prevents the untraded part of a Limit Order from being retained). The BOX Trading Host will automatically withdraw all Limit Orders, except for those with a Good ''Til Cancelled (''GTC'') designation, at market close.[67]

Market-on-Opening Orders entered into the BOX Book are executed on the market opening at the best price available in the market until all available volume on the opposite side of the market has been traded. Any residual volume left after part of a Market-on-Opening Order has been executed is automatically converted to a Limit Order at the price at which the original Market-on-Opening Order was executed. Market-on-Opening Orders have priority over Limit Orders.[68]

BOX-Top Orders entered into the BOX Book are executed at the best price available in the market for the total quantity available. Any residual volume left after part of a BOX-Top Order has been executed is automatically converted to a Limit Order at the price at which the original BOX-Top Order was executed.[69]

One commenter suggests that BOX-Top Orders should continue through the price discovery process instead of being converted to a Limit Order after being partially executed. In addition, this commenter raises a concern that if a BOX-Top Order is converted to a Limit Order and the market moves away from the limit price, the proposal does not specify whether the BOX system would update the order price to the next limit or whether it would remain at the initial limit price. This commenter believes that if the order remains at the initial limit price, it would be negatively impacted.[70]

The Commission believes that the proposal clearly specifies the procedures regarding the handling of BOX-Top orders. Unlike market orders that trade at successive price levels, BOX-Top Orders would execute at the best price available in the market for the total quantity available from any contra side order. Any remaining volume would be automatically converted to a Limit Order at the price that the original BOX-Top Order was executed. This limit price would not change due to market fluctuations. Thus, the Commission does not believe any clarification is necessary regarding BOX-Top Orders. The Commission also believes that brokers who send a Customer's order to BOX as a BOX-Top Order must be sure that such an order type is consistent with that Customer's expectations.

ii. Order Designations

Among several designations that can be added to BOX-Top or Limit Orders [71]

[54] *See* proposed BOX Rules, Chapter VI, sec. 5(a).

[55] *See* proposed BOX Rules, Chapter VI, sec. 6(a).

[56] *See* proposed BOX Rules, Chapter VI, sec. 6(d)(i).

[57] *See* proposed BOX Rules, Chapter VI, sec. 5(a). These quotes must be consistent with the spread parameters in Chapter VI, section 5(a)(vii) of the proposed BOX Rules.

[58] *See* proposed BOX Rules, Chapter VI, sec. 2 and sec. 9, and Chapter XXII, sec. 2.

[59] The term, ''RFQ,'' refers to a message that may be issued by an Options Participant in order to signal an interest in an options series and request a response from other Participants. *See* proposed BOX Rules, Chapter I, sec. 1(a)(54); Chapter VI, sec. 6(b)(ii). *See also* Amendment No. 4, supra note 11. In Amendment No. 4, the BSE changed the RFQ period from 15 seconds to three seconds, in response to concerns raised by commenters.

[60] *See* proposed BOX Rules, Chapter VI, sec. 5(f).

[61] *See* 12 CFR 221.5(c)(6).

[62] *See* PCX Letter 2, *supra* note 10, at Appendix at 12.

[63] *See* 15 U.S.C. 78c(a)(38) (definition of ''market maker'').

[64] *See* CBOE Rule 8.7, Interpretation .03A.

[65] *See* proposed BOX Rules, Chapter V, sec. 14.

[66] These include a Good ''Til Cancelled designation, Fill and Kill designation, Fill-or-Kill designation, and Minimum Volume designation. A Good ''Til Cancelled, Fill and Kill, or Fill-or-Kill designation can be added to Limit Orders. A Minimum Volume designation can be added to both Limit Orders and BOX-Top orders. *See* proposed BOX Rules, Chapter V, sec. 14(d).

[67] *See* proposed BOX Rules, Chapter V, sec. 14(c)(i).

[68] *See* proposed BOX Rules, Chapter V, sec. 14(c)(iii).

[69] *See* proposed BOX Rules, Chapter V, sec. 14(c)(ii).

[70] *See* PCX Letter 2, *supra* note 10, at Appendix at 3.

[71] *See* proposed BOX Rules, Chapter V, sec. 14(d)(i)(1)–(3).

is the Minimum Volume (''MV'') designation. MV orders would be executed only if the specified minimum volume were immediately available to trade (at the specified price or better in the case of Limit Orders). If the specified minimum volume were not immediately available, the BOX Trading Host would automatically cancel the order. In the case of Limit Orders, where a volume equal to or greater than the specified minimum volume of an MV order trades, the size remaining in an order would be filtered through the BOX National Best Bid and Offer (''NBBO'') filter mechanism [72] and placed on the BOX Book. In the case of BOX-Top Orders, where a volume equal to or greater than the specified minimum volume of an MV order has traded, the size remaining in an order would be converted to a Limit Order at the price at which the BOX-Top Order was executed, filtered through the BOX NBBO filter mechanism, and placed on the BOX Book.[73]

One commenter queries how MV orders would be represented, which Options Participants would be able to view them, and how they might be traded-through when the minimum volume cannot be satisfied.[74] In response, in Amendment No. 4, the BSE explains that MV orders would not ''lurk'' on the book undisplayed. MV orders would either trade immediately for at least the minimum specified size or immediately be cancelled. As noted above, any size remaining in a Limit Order or BOX-Top Order would be protected against trading through better prices on other markets by being filtered through the BOX NBBO filter mechanism.[75]

b. Order Ranking and Display

The BOX Book is the electronic book of orders maintained by the BOX Trading Host. The BOX Book contains all orders of Options Participants. Limit Orders of Options Participants submitted to BOX would be ranked and maintained in the BOX Book according to price/time priority, such that within each price level, all orders would be organized by the time of entry.[76] No distinction is made to this priority with regard to account designation (Public Customer, Broker/Dealer or Market Maker). An Options Participant must submit a new order if it wishes to refresh its order. This new order would be ranked at the specified limit price according to the time that the new order was entered.

Trades would occur when orders or quotations match on the BOX Book. Orders at the same price would have priority based on the time of order entry, as described above.[77] Limit Orders would trade immediately with any orders already in the BOX Book at or better than the limit price, up to the available size.[78] Any size remaining of the Limit Order would be filtered to ensure that it does not trade at a price outside the NBBO [79] before being placed on the BOX Book.

One commenter expressed concern that BOX participants might have the ability to see market information via BOX's internal network on a timelier basis than that information would be provided to OPRA. In particular, the commenter claims that BOX's marketing documents suggest that BOX Options Participants would have faster access to BOX market information than OPRA.[80] BOX represents, however, that it will not provide information in a more-timely manner on its internal network than it will send that information to OPRA.[81]

3. Opening the Market

The BOX market will conduct a single price opening. Orders may be submitted, modified, and cancelled throughout a pre-opening phase preceding the commencement of trading on the market. During this pre-opening phase, Customers may submit only Market-on-Opening or Limit Orders. BOX would calculate a theoretical opening price and broadcast it to all BOX market participants through the pre-opening phase.[82] Thereafter, BOX would determine a single price at which a particular options series would open.[83] The determination of the opening match price in each series of options would be held promptly following the opening of the underlying security in the primary market where it is traded.[84] However, BOXR may delay the opening match in any class of options in the interests of a fair and orderly market.[85]

If the BOX market is crossed (bids higher than offers) at the market open, BOX would determine the price at which the maximum volume can be traded and automatically execute trades accordingly, pursuant to BOX Rules, Chapter V, Sec. 9 (Opening the Market).[86] Any orders executed in this way would be traded at a price equal to or better than that at which they were entered and any untraded bids and offers would remain on the BOX Book.[87]

One commenter asks that BOX clarify how it intends to treat the opening of trading of Market-on-Opening Orders on BOX. This commenter suggests that the use of Market-on-Opening Orders in the opening process seems to imply that BOX would trade at multiple prices during the opening.[88] In Amendment No. 4, the BSE proposes to correct the typographical error in the definition of Market-on-Opening Order to eliminate any implication that BOX would trade at multiple prices during the market opening.[89] Moreover, the BOX Rules specifically state that BOX would determine a single price at which a particular series would be opened.[90]

However, the Commission believes that the proposed rules do not sufficiently describe the procedures for determining the single opening price for an options series on the BOX market. Accordingly, the Commission's approval of the proposed rule change is on the condition that the proposed rule change is not effective until a proposed rule change to amend the BOX Rules to provide a more detailed description of the market opening procedures becomes

[72] *See infra* section II.C for a discussion of the BOX NBBO Filter process.

[73] *See* proposed BOX Rules, Chapter V, sec. 14(d)(i)(4).

[74] *See* PCX Letter 2, *supra* note 10, at Appendix at 3.

[75] *See* Amendment No. 4, *supra* note 11.

[76] *See* proposed BOX Rules, Chapter V, sec. 16(a)(i).

[77] *See* proposed BOX Rules, Chapter V, sec. 16(a)(iv)(2).

[78] *See* proposed BOX Rules, Chapter V, sec. 16(a)(iv)(3).

[79] *See infra* notes 124–135 and accompanying text.

[80] *See* PCX Letter 2, *supra* note 10, at Appendix at 13.

[81] *See* Amendment No. 4, *supra* note 11.

[82] The theoretical opening price is the price at which the opening trades would occur if the opening were to commence at that given moment. *See* proposed BOX Rules, Chapter V, sec. 9(a).

[83] *See* proposed BOX Rules, Chapter V, sec. 9(b).

[84] *See* proposed BOX Rules, Chapter V, sec. 9(c).

[85] *See* proposed BOX Rules, Chapter V, sec. 9(e).

[86] One commenter, responding to the Amendment No. 3 Notice, *supra* note 9, suggests that the proposed uncrossing algorithm to calculate the price at which the maximum volume could be traded was ambiguous. Specifically, the commenter suspects that the uncrossing mechanism employed could select a price at which customers would pay more (sell for less) at one of the uncrossing algorithm-selected prices to the benefit of professionals. *See* PCX Letter 2, *supra* note 10, at Appendix at 3. The Commission notes, however, that the ''uncrossing algorithm''referred to in Chapter V, section 16(a)(v) was actually intended as a cross reference to the BOX ''opening match,'' which is discussed in detail under Chapter V, section 9 of the proposed BOX Rules. Therefore, in Amendment No. 4, BSE proposes to change the reference from ''uncrossing algorithm'' to ''opening match'' to remove any confusion. *See* Amendment No. 4, *supra* note 11.

[87] *See* proposed BOX Rules, Chapter V, sec. 16(a)(v); *see also* Amendment No. 4, *supra* note 11.

[88] *See* PCX Letter 2, *supra* note 10, at Appendix at 1–2.

[89] *See* proposed BOX Rules, Chapter V, sec. 14(c)(iii); *see also* Amendment No. 4, *supra* note 11.

[90] *See* proposed BOX Rules, Chapter V, sec. 9(b).

effective under section 19(b) of the Act.[91]

4. Unusual Market Conditions

Rule 11Ac1–1 under the Act, known as the ''Quote Rule,'' requires, among other things, that exchanges collect, process, and make available to quotation vendors the best bids and offers which are communicated on the exchange.[92] In addition, each responsible broker or dealer must execute orders presented to it at a price at least as favorable as its best bid or offer in any amount up to the size of that bid or offer, subject to certain exceptions.[93] The BSE has proposed a rule to relieve responsible brokers or dealers from their obligations under the Quote Rule when the level of trading activities or the existence of unusual market conditions is such that the BSE is incapable of collecting, processing, and making available to quotation vendors the data for the option class in a manner that accurately reflects the current state of the market on BOX.[94] An Options Official would have the authority to determine that the level of trading activities or the existence of unusual market conditions is such that BOX is incapable of collecting, processing, and making available to quotation vendors the data for the option class in a manner that accurately reflects the current state of the market on BOX.[95] In such circumstances, an Options Official, an officer of BOXR, would be permitted to: (i) Suspend the minimum size requirement with respect to Market Maker quotations; (ii) turn off the PIP; [96] or (iii) take such other actions as are deemed in the interest of maintaining a fair and orderly market.[97]

The Commission believes that the proposed rule is consistent with the Act and the Quote Rule, and notes that the BSE is required to enforce compliance by its members with the Federal securities laws and the BOX Rules.[98] Accordingly, the Commission expects that the BSE will ensure that sufficient monitoring procedures are in place to fully implement the requirements of the Quote Rule. One commenter suggests that the BSE automate the process of turning off the PIP, described below, when the exchange is relieved of its obligations under the Quote Rule.[99] The Commission does not believe that such automation is required to make the BSE's proposal consistent with the Act and that an Options Official's discretion to turn off the PIP during unusual market conditions is consistent with an exchange official's authority on other options exchanges to take action during unusual market conditions.[100]

5. Complex Orders

A Complex Order is any order for the same account, that is composed of two or more related orders intended to be executed concurrently as part of a single investment strategy, including, among other things, combination orders with non-equity options legs.[101]

One commenter raises the following questions with respect to Complex Orders: (i) Is there a Complex Order Book; (ii) how will Options Participants know of Complex Orders; (iii) will Complex Orders be separately disseminated; (iv) are OFPs required to monitor and execute complex orders like Public Customer PIP Orders (''CPOs''); and (v) does BOX plan to provide separate Exchange staff to monitor Complex Orders and the Complex Order Book? [102]

In Amendment No. 4, the BSE provides further explanation in response to the commenter's questions. The BSE states that there would be a Complex Order Book on BOX, and that BSE's proposal regarding Complex Orders is consistent with the current trading of Complex Orders by the existing options exchanges.[103] Prior to entry of a Complex Order on the Complex Order Book, a BOX Participant would be required to notify BOX of the legs of the strategy it proposes to submit.[104] If the proposed strategy is valid, BOX would send an ''advisory'' message notifying all BOX Participants of such proposed strategy and the time at which it would start trading.[105] BOX would maintain a listing, accessible to all BOX Participants, of all Complex Order strategies available for trading on BOX. The BSE's proposed rules do not specify the process for BOX Participants to notify BOX of a proposed strategy or the procedures for sending advisory messages. Accordingly, the Commission's approval of this proposed rule change will not be effective until BSE files a separate proposed rule change with the Commission to include these required procedures in its rules that becomes effective pursuant to section 19(b) of the Act.

The BSE further represents that Complex Orders would be submitted, modified, and cancelled like other orders on BOX.[106] The Complex Orders would be separately disseminated by BOX through a broadcast to all BOX Participants showing the five best limit prices for each strategy. Complex Orders would not be disseminated to OPRA. OFPs would not be required to monitor and execute Complex Orders like CPOs. Complex Orders sent to BOX by OFPs would be maintained on the BOX Book and would be automatically executed on a price and time priority basis when a matching Complex Order is received by BOX.

The BSE does not plan to have separate Exchange staff to monitor Complex Orders and the Complex Order Book. The BSE believes that because of the overall integration of the BOX Trading Host, of which the Complex Order trading system is one element, the same staff which monitors the Trading Host and the BOX Book would have the appropriate resources and expertise to monitor Complex Order trading.[107]

Another commenter asserts that the BOX provision appears contrary to price and time priority rules of other options exchanges because an options leg of a transaction would take priority over other orders at the same price.[108] In response, the BSE, in Amendment No. 4, proposes that the option leg of a stock-option order or a SSF-options order would be executed according to price-time priority as set forth in the proposed BOX Rules, Chapter V, Sec. 16. In addition, the BSE proposes that for combination orders with multiple options legs, if the best bid or offer on BOX is a Customer Limit Order, the Complex Order would have priority over any bid or offer in BOX, regardless of time priority, only if at least one leg of the Complex Order trades at a price better than the best price available on BOX.

A third commenter questions whether Complex Orders would interact in the PIP.[109] In response, BSE proposes to

[91] 15 U.S.C. 78s(b).

[92] 17 CFR 240.11Ac1–1(b)(1).

[93] 17 CFR 240.11Ac1–1(c).

[94] *See* proposed BOX Rules, Chapter VI, sec. 6(c)(ii)(2).

[95] *See* proposed BOX Rules, Chapter V, sec. 13(a).

[96] *See infra* section II.E.1 for a description of the PIP.

[97] *See* proposed BOX Rules, Chapter V, sec. 13(b); *see also* Amendment No. 4, *supra* note 11.

[98] *15 U.S.C. 78f(b)(1).*

[99] *See* Amex Letter 2, *supra* note 10, at 5.

[100] *See, e.g.*, ISE Rule 704(c).

[101] *See* proposed BOX Rules, Chapter V, sec. 27(a)(i)–(ix).

[102] *See* Amex Letter 3, *supra* note 10, at 5.

[103] *See, e.g.*, ISE Rule 722.

[104] Telephone conversations between Will Easley, Business Development Manager, BOX, Wayne Peston, Bingham McCutchen, and Elizabeth King, Deborah Flynn, John Roeser, and Susie Cho, Division, Commission on January 7, 2004.

[105] *Id.*

[106] *See* Amendment No. 4, *supra* note 11.

[107] *See* Amendment No. 4, *supra* note 11.

[108] *See* PCX Letter 2, *supra* note 10, at Appendix at 11.

[109] Telephone call between James Harkness, Christopher Gust, Robert Bellick, Matthew Abraham, and Judy Kula, Wolverine Trading, and

Continued

amend its proposed rules to explicitly prohibit Options Participants from submitting Complex Orders either to BOX as Directed Orders or to the PIP.[110]

The Commission believes that the modifications proposed by the BSE in Amendment No. 4 clarify the priority of Complex Orders relative to the Limit Orders of Customers. Specifically, the BSE's modified proposal is now consistent with the rules of other exchanges, regarding the priority of Complex Orders with multiple options legs. Unlike the other options exchanges, the BSE proposes not to provide Public Customer Orders with priority over Complex Orders at the same price, unless such Public Customer Order had time priority. Despite this difference, the Commission finds the proposed BOX Rules relating to Complex Orders to be consistent with the Act.

6. Obvious Error Rule

The BSE proposes to permit BOXR to either break a transaction or adjust the execution price of a transaction that results from an obvious error. Under the proposed rule, an obvious error would be deemed to have occurred when the execution price of a transaction is higher or lower than the theoretical price for the series by an amount equal to at least: $.25 where the theoretical price is below $2; $.40 where the theoretical price is $2–$5; $.50 where the theoretical price is above $5–$10; $.80 where the theoretical price is above $10–$20; and $1.00 where the theoretical price is above $20.[111] If the series is traded on at least one other options exchange, the theoretical price of an options series would be the last bid price with respect to an erroneous sell transaction, and last offer price with respect to an erroneous buy transaction, just prior to the trade, disseminated by the competing options exchange that has the most liquidity in the option. If there were no quotes for comparison purposes, the theoretical price would be determined by the BSE Market Control Center (''MRC'').[112] The proposed obvious error rule provides for a procedure whereby an Options Participant may notify the MRC if it believes an order it executed on BOX was the result of an obvious error.[113] A party to the trade that disagrees with the determination of the MRC can appeal the determination to the BOXR Chief Regulatory Officer.[114]

One commenter suggests that BOX should define what it means when it refers to the exchange with the ''most liquidity'' under the obvious error rule.[115] In response, BOX proposes to amend the rule to describe specifically how it would determine which is the options exchange with the most liquidity.[116]

The Commission believes that, in most circumstances, trades that are executed between parties should be honored. On rare occasions, the price of the executed trade indicates an ''obvious error'' may exist, suggesting that it may be unrealistic to conclude that the parties to the trade had come to a meeting of the minds regarding the terms of the transaction. In the Commission's view, the determination of whether such an ''obvious error'' has occurred should be based on specific and objective criteria and subject to specific and objective procedures. The Commission believes that the BSE's proposed obvious error rule establishes specific and objective criteria for determining when a trade is an ''obvious error.'' The Commission also believes that the proposal establishes specific and objective procedures governing the adjustment or nullification of such trade. The Commission further notes that several provisions of the BOX obvious error rule are substantially the same as the obvious error rule of another options exchange, which was recently approved by the Commission.[117]

7. Cabinet Trading

As originally proposed, the BOX Rules did not contain any provisions with regard to cabinet trades (also known as accommodation liquidations), generally transacted at the expiration of worthless options for tax purposes. One commenter suggests that the BOX proposal should include provisions relating to cabinet trading and how the BSE intends to regulate cabinet trading.[118]

In response, the BSE proposes, in Amendment No. 4, to permit cabinet trading in each series of options contracts open for trading on BOX.[119] The proposed cabinet trading rules are substantially similar to the cabinet trading rules of the other options exchanges[120] and the Commission believes they are consistent with the Act.

8. Anticipatory Hedge Rule

The BSE has not proposed a rule that would prohibit what is known as ''anticipatory hedging.'' All of the options exchanges have anticipatory hedging rules, which generally prohibit a member that has knowledge of all material terms of a solicited order, an order being facilitated, or orders being crossed, the execution of which is imminent, from buying or selling (1) an option on the same underlying security as the option that is the subject of the order, (2) the underlying security itself, or (3) any related instrument until either the terms of the order are disclosed to the trading crowd or the options order can no longer be considered imminent in view of the passage of time since the order was received.[121] The Commission believes that the options exchanges' anticipatory hedging rules prevent the misuse of non-public information and afford trading crowds a full and fair opportunity to make informed trading decisions.[122] In addition, the Commission believes that anticipatory hedging could threaten the integrity of the auction market or disadvantage other market participants.[123] Accordingly, the Commission's approval of this proposed rule change will not be effective until BSE files a separate proposed rule change with the Commission to adopt an anticipatory hedging rule comparable to those of the other options exchanges that becomes effective pursuant to section 19(b) of the Act.

Bob Colby, Elizabeth King, Deborah Flynn, John Roeser, and Susie Cho, Division, Commission, on November 12, 2003.

[110] Proposed BOX Rules, Chapter V, section 27(b)(v); *see also* Amendment No. 4, *supra* note 11.

[111] *See* proposed BOX Rules, Chapter V, sec. 20(b); *see also* Amendment No. 4, *supra* note 11.

[112] *See* proposed BOX Rules, Chapter V, sec. 20(c); *see also* Amendment No. 4, *supra* note 11.

[113] *See* proposed BOX Rules, Chapter V, sec. 20(d); *see also* Amendment No. 4, *supra* note 11.

[114] *See* proposed BOX Rules, Chapter V, sec. 20(e); *see also* Amendment No. 4, *supra* note 11.

[115] *See* PCX Letter 2, *supra* note 10, at Appendix at 10.

[116] *See* proposed BOX Rules, Chapter V, sec. 20, Supp. Mat. .03; *see also* Amendment No. 4, *supra* note 11.

[117] *See* ISE Rule 720; *see also* Securities Exchange Act Release No. 48097 (June 26, 2003), 68 FR 39604 (July 2, 2003) (SR–ISE–2003–10) (order approving amendments to ISE's obvious error rule).

[118] *See* PCX Letter 2, Appendix at 13.

[119] *See* proposed BOX Rules, Chapter V, sec. 28; *see also* Amendment No. 4, *supra* note 11.

[120] *See, e.g.*, ISE Rule 718; CBOE Rule 6.54; and PCX Rule 6.80.

[121] *See* Amex Rule 950(d), Commentary .04; CBOE Rule 6.9(e); ISE Rule 400, Supplementary Material .02; PCX Rule 6.49(b); and Phlx Rule 1064(d).

[122] *See* Securities Exchange Act Release No. 44208 (April 20, 2001), 66 FR 21423 (April 30, 2001) (SR–ISE–01–02).

[123] *See* Securities Exchange Act Release Nos. 42894 (June 2, 2000), 65 FR 36850 (June 12, 2000) (SR–Amex–99–36); and 34959 (November 9, 1994), 59 FR 59446 (November 17, 1994) (SR–CBOE–94–15).

C. Filtering of BOX In-Bound Orders To Prevent Trade-Throughs

All in-bound agency orders to BOX (whether on behalf of Customers, non-BOX Participant broker-dealer proprietary accounts or market makers at other exchanges) as well as inbound Principal (''P'') and Principal as Agent (''P/A'') orders received via the intermarket linkage [124] would be filtered by BOX prior to entry on the BOX Book to ensure that these orders do not trade at a price outside the current NBBO (''trade-throughs''). The filter would operate by analyzing all such orders as follows:

Step 1: If the order were a BOX-Top Order, BOX would handle the order in the following manner:

Where the best price on the BOX Book on the opposite side of the market from the BOX-Top Order is equal to the NBBO, the BOX-Top Order would be executed for all the quantity available on the BOX Book at this price. Any remaining quantity would be converted to a Limit Order at this execution price and filtered as described in steps 2 through 4 below.[125]

If the best bid (offer) disseminated by BOX were not equal to the NBBO, the BOX-Top Order to sell (buy) would be converted to a Limit Order for its total quantity at a price equal to the NBBO and filtered as described in steps 2 through 4 below.[126]

Step 2: The filter would determine whether the order is executable against the NBBO.[127] If the order were not executable against the NBBO, the order would be placed on the BOX Book at its limit price, unless the order were a P or P/A Order, in which case it would be immediately cancelled.[128] If the order were executable against the NBBO, the filter would determine whether there is a quote on BOX that is equal to the NBBO.

Step 3: If there were a quote on BOX that is equal to the NBBO, then the order would be executed against that quote. Any remaining quantity of the order would be exposed on the BOX Book at the price the order was partially executed for a period of three seconds. During the exposure period, any Options Participant may trade with the order. If the order were not executed during the three-second exposure period, then the order would be handled by BOX pursuant to Step 4 below.[129]

With respect to P and P/A Orders in which the size of a P/A Order is larger than the Firm Customer Quote Size or the size of a P Order is larger than the Firm Principal Quote Size, and any quantity remains after trading against the BOX quote at the NBBO, then such remaining quantity would be exposed on the BOX Book at the price the order was partially executed for a period of three seconds. During the exposure period, any Options Participant may trade with the order. Any quantity remaining on the BOX Book after the three-second exposure period would be cancelled. BOX would inform the sending Participant exchange of the amount of the order that was executed and the amount, if any, cancelled.[130]

If there were not a quote on BOX that is equal to the NBBO, then the order, unless such order is a P or P/A Order, would be exposed on the BOX Book at the NBBO for a period of three seconds. During the exposure period, any Options Participant may trade with the order. If the order were not executed during the three-second exposure period, then the order would be handled by BOX pursuant to Step 4 below.[131] However, if the order were a P or P/A Order, it would not be exposed for the three-second period and, instead, would be immediately cancelled.

Step 4: At the end of the three-second exposure period, any unexecuted quantity of an order would be handled by BOX in one of the following ways:

(1) If the best BOX price were now equal to the NBBO, the remaining unexecuted quantity would immediately trade with that quote or order. Any remaining quantity would be (i) in the case of a Public Customer Order, sent as a P/A Order to an exchange displaying the NBBO; or (ii) in the case of a market maker or proprietary broker-dealer order, returned to the submitting Options Participant; [132]
or

(2) If the best BOX price is not equal to the NBBO, then any remaining unexecuted quantity would be (i) in the case of a Public Customer Order, sent as a P/A Order to an exchange displaying the NBBO; or (ii) in the case of a market maker or proprietary broker-dealer order, returned to the submitting Options Participant.[133]

One commenter asks for more clarity regarding which BOX participants will be able to view the internal message disseminating the in-bound order in the BOX filter.[134] The Commission does not agree with the commenter that the BOX Rules are unclear with respect to order exposure on the BOX book during the filter process, as the proposed rules state that the order would be exposed on the BOX Book.[135]

The Commission believes that the proposed rules regarding the NBBO filter process are in accordance with Section 6(b)(5) of the Act [136] because they are designed to facilitate transactions in securities, and remove impediments to and perfect the mechanism of a free and open market and national market system. The NBBO filter is designed to protect against incoming agency orders trading at prices that trade through better prices on other markets as required under the Linkage Plan.[137] In addition, the Commission believes that the BOX NBBO filter rules outlined above should allow Market Makers and OFPs to provide efficient and competitive executions for in-bound agency orders, subject to priority and allocation principles.

D. Directed Orders Process

Under BSE's proposal, a ''Directed Order'' refers to a Customer Order that an OFP directs to a particular Market Maker.[138] A Market Maker who wishes to accept Directed Orders must systemically indicate that it wishes to receive Directed Orders each day, must be willing to accept Directed Orders from all OFPs, may receive Directed

[124] Plan for the Purpose of Creating and Operating an Intermarket Options Linkage (the ''Linkage Plan''). *See* Securities Exchange Act Release Nos. 43086 (July 28, 2000), 65 FR 48023 (August 4, 2000) (order approving the Linkage Plan submitted by the Amex, CBOE, and ISE); 43574 (November 16, 2000), 65 FR 70850 (November 28, 2000) (order approving PCX as participant in Options Intermarket Linkage Plan); and 43573 (November 16, 2000), 65 FR 70851 (November 28, 2000) (order approving Phlx as participant in the Linkage Plan).

[125] *See* proposed BOX Rules, Chapter V, sec. 16(b)(ii)(1).

[126] *See* proposed BOX Rules, Chapter V, sec. 16(b)(ii)(2).

[127] The BSE has clarified in Amendment No. 4 that an order would be deemed ''executable against the NBBO'' when, in the case of an order to sell (buy), its limit price is equal to or lower (higher) than the best bid (offer) across all options exchanges. All BOX-Top Orders are deemed to be executable against the NBBO. *See* Amendment No. 4, *supra* note 11.

[128] *See* proposed BOX Rules, Chapter V, sec. 16(b)(iii)(1); *see also* Amendment No. 4, *supra* note 11.

[129] *See* proposed BOX Rules, Chapter V, sec. 16(b)(iii)(2)(a); *see also* Amendment No. 4, *supra* note 11.

[130] *Id.*

[131] *See* proposed BOX Rules, Chapter V, sec. 16(b)(iii)(b); *see also* Amendment No. 4, *supra* note 11.

[132] *See* proposed BOX Rules, Chapter V, sec. 16(b)(iii)(c)(1); *see also* Amendment No. 4, *supra* note 11.

[133] *See* proposed BOX Rules, Chapter V, sec. 16(b)(iii)(c)(2); *see also* Amendment No. 4, *supra* note .

[134] *See* PCX Letter 2, *supra* note, at Appendix at 4.

[135] *See* proposed BOX Rules, Chapter V, sec. 16(b); *see also* Amendment No. 4, *supra* note 11.

[136] 15 U.S.C. 78f(b)(5).

[137] *See infra* notes 282–289 and accompanying text.

[138] *See* proposed BOX Rules, Chapter I, sec. 1(a)(21); *see also* Amendment No. 4, *supra* note 11.

Orders only through the BOX Trading Host, and may not reject Directed Orders.[139]

A Market Maker receiving a Directed Order would have to, within three seconds of receipt of the order, either submit the Directed Order to the PIP, discussed below,[140] or send the order to the BOX Book.[141] If the Market Maker submits the order to the PIP and is quoting at the NBBO on the opposite side of the Directed Order, it would be prohibited from changing its quotation prior to submitting the Directed Order to the PIP.[142] If the Market Maker sends the Directed Order to the BOX Book (or BOX releases the order to the book) the following rules would apply.

First, the Market Maker sending the Directed Order to the BOX Book would be prohibited for three seconds from submitting to BOX a contra order to the Directed Order for its proprietary account.[143] This requirement would allow the Directed Order to be exposed to other market participants to give them the opportunity to trade with the Directed Order.

Second, if the Market Maker's quotation on the opposite side of the market from the Directed Order is not equal to the NBBO, immediately upon the submission of the Directed Order to BOX, the Trading Host would determine if the Directed Order is executable against the NBBO according to the NBBO filter process discussed above.[144] If the Market Maker's quotation on the opposite side of the market from the Directed Order were equal to the NBBO, then prior to submitting the Directed Order to the BOX Book, the Market Maker would determine whether the Directed Order is executable against the NBBO.[145]

Third, if the Directed Order were not executable against the NBBO, it would be placed on the BOX Book to be treated as any other order.[146] If the Directed Order were executable against the NBBO, and the Market Maker sending the Directed Order to the BOX Book has a quote on the opposite side of the Directed Order equal to the NBBO, then the Market Maker must guarantee execution of the Directed Order at the current NBBO for at least the size of its current quote.[147] This guarantee would be defined as a Guaranteed Directed Order (''GDO'').[148] The Market Maker must then immediately send the Directed Order and the GDO to the BOX Book. If the Directed Order were executable against the NBBO and the Market Maker sending the Directed Order to the BOX Book does not have a quote on the opposite side of the market equal to the NBBO, the Trading Host would execute the Directed Order against any quotes or orders on the BOX Book equal to the NBBO and then filter the order against trading through the NBBO and, if applicable, then place the Directed Order on the BOX Book.[149] The Directed Order would trade against any quotes or orders on the BOX Book, except the GDO,[150] and any quantity remaining would be exposed to all BOX Participants at the GDO price for three seconds. During this period, any BOX Participant, except the Market Maker who submitted the Directed Order, could trade with the Directed Order.[151] After three seconds of exposure, BOX would release the GDO, which would trade with any remaining quantity of the Directed Order.[152] If there were still any quantity remaining of the Directed Order, it would be filtered against trading through the NBBO according to the procedures described above. If the Directed Order were not executed or routed to another exchange through the filter process, it would then be placed on the BOX Book.[153]

Some commenters argue that the Directed Order process amounts to preferencing or internalization by the Market Makers, which would threaten market integrity.[154] In addition, some commenters contend that Directed Orders would allow payment for order flow, an arrangement where a Market Maker would offer an order entry firm cash or other economic inducement to route its Directed Orders to that firm.[155]

The Commission believes, however, that the proposed restrictions on Market Makers receiving Directed Orders described above should limit the Market Maker's ability to internalize these orders without undermining competitive markets. In particular, the Commission believes that the Directed Order process will not jeopardize market integrity or the incentive for market participants to post competitive quotes because Market Makers receiving Directed Orders must accept all orders directed to them and must send such orders only to the PIP or to the BOX Book, and because a Market Maker is prohibited from interacting with a Directed Order it receives for three seconds, regardless of the price at which the Market Maker was quoting when the Directed Order was received.

One commenter suggests that the BSE's proposal would penalize Market Makers that quote at the NBBO because, if the Market Maker that receives the Directed Order were quoting at the NBBO at the time it receives the Directed Order, it would be required to couple the Directed Order with a GDO, guaranteeing the execution of the Directed Order at the then-current NBBO for at least the size of the Market Maker's quotation.[156] Moreover, the Market Maker's quotation loses any priority it may have had at the NBBO because its GDO is not released for the three-second exposure period, and the Market Maker would trade only when all other trading interest is exhausted.[157] Also, this commenter argues that the proposed BOX market would provide a strong incentive to maintain wide quotations and to quote in small size because, among other things, Market

[139] *See* proposed BOX Rules, Chapter VI, sec. 5(c)(i); *see also* Amendment No. 4, *supra* note 11. If a Market Maker does not systemically indicate that it will receive Directed Orders, the BOX Trading Host will not forward any Directed Orders to that Market Maker.

[140] *See infra* notes 169–252 and accompanying text.

[141] If, three seconds after receipt of a Directed Order, a Market Maker has not taken any action on the Directed Order, BOX will automatically release the Directed Order to the BOX Book. *See* proposed BOX Rules, Chapter VI, sec. 5(c)(ii)(2); *see also* Amendment No. 4, *supra* note 11.

[142] *See* proposed Box Rules, Chapter VI, sec. 5(c)(ii)(1); *see also* Amendment No. 4, *supra* note 11.

[143] *See* proposed BOX Rules, Chapter VI, secs. 5(c)(iii)(2)(a) and 5(c)(iii)(1)(a); *see also* Amendment No. 4, *supra* note 11. According to the BSE, BOX surveillance systems would detect violations of the three-second requirement. *See* Amendment No. 4, *supra* note 11.

[144] *See* proposed BOX Rules, Chapter VI, sec. 5(c)(iii)(1). See also *supra* notes 124–137 and accompanying text.

[145] *See* proposed BOX Rules, Chapter VI, sec. 5(c)(iii)(2).

[146] *See* proposed BOX Rules, Chapter VI, secs. 5(c)(iii)(1)(b) and 5(c)(iii)(2)(a).

[147] *See* proposed BOX Rules, Chapter VI, sec. 5(c)(iii)(2)(b).

[148] The Market Maker would be prohibited from trading from its proprietary account against the Directed Order for at least three seconds. During that time the Market Maker would not be allowed to decrement the size or worsen the price of its GDO, but could increase the size of its GDO. If the Market Maker received a subsequent Directed Order during this three-second period it would be able to either submit it to the PIP or send it to the BOX Book, following the same process as for the first Directed Order. *See* proposed BOX Rules, Chapter VI, sec. 5(c)(iii)(2)(b).

[149] *See* proposed BOX Rules, Chapter VI, sec. 5(c)(iii)(1)(c).

[150] *See* proposed BOX Rules, Chapter VI, sec. 5(c)(iii)(2)(b)(2).

[151] *See* proposed BOX Rules, Chapter VI, sec. 5(c)(iii)(2)(b)(3).

[152] *See* proposed BOX Rules, Chapter VI, sec. 5(c)(iii)(2)(b)(4). Unless modified by the Market Maker, BOX would reestablish the quote of the Market Maker decremented by any executed portion of the GDO. *Id.*

[153] *See* proposed BOX Rules, Chapter VI, sec. 5(c)(iii)(2)(b)(5).

[154] *See* Amex Letter 3, *supra* note 10, at 4–5; ISE Letter 2, *supra* note 10, at 10.

[155] *See* Amex Letter 3, *supra* note 10, at p. 4; CBOE Letter 2, *supra* note 10, at p.9; and ISE Letter 2, *supra* note 10, at p. 9.

[156] *See* ISE Letter 2, *supra* note 10, at 12.

[157] *Id.*

Makers could receive Directed Orders from small Customers—the most attractive order flow available—regardless of the quality of their quotations.[158] Finally, the commenter argues that the Commission should permit Directed Orders only if the proposal would: (1) Prohibit sending Directed Orders to a Market Maker not quoting at the inside market; and (2) prohibit an OFP from sending Directed Orders to a Market Maker for a size larger than the Market Maker's then-current quotation.[159]

The Commission, however, does not believe that it is necessary for these restrictions to be included in the BOX Rules to be consistent with the Act. In response to the other comments raised by this commenter, the BSE has changed its proposal to clarify that a Market Maker, who receives a Directed Order when not quoting at the NBBO, as well as when quoting at the NBBO, would have to wait three seconds before trading with the Directed Order.[160] This provision would allow the Directed Order to be exposed to other market participants to give them the first opportunity to trade with the Directed Order. Accordingly, the Commission believes that the Directed Order process would not provide any disincentive for Market Makers who receive Directed Orders to quote competitively, and may, in fact, provide some incentive for other Market Makers to quote competitively because it will give them priority with respect to all other orders entered onto the BOX Book, including orders directed to other Market Makers.

Currently, the rules of several of the SROs impose certain restrictions on the business activities of a member or member organization that is affiliated with a specialist or member organization. The requirements in the BOX Rules regarding Directed Orders are intended to address any concerns regarding informational barriers and the transfer of information (intended or not) between Options Participants. To this effect, as noted above, under the BOX Rules, a BOX Market Maker who decides to accept Directed Orders, must agree to accept them from all sources. Upon receipt of a Directed Order, a Market Maker has only two choices—either submit the order into the PIP, or send the order back to the BOX Book.

The BSE has proposed a number of safeguards designed to limit the disclosure of market information, the description of which follows in section II.E. These proposed measures should help to ensure that information is not used inappropriately for the benefit of the Market Maker receiving the Directed Order.

E. Rules To Limit Internalization

Following the widespread multiple listing of options in the fall of 1999, a number of broker-dealers handling customer orders pressured the options exchanges to allow them to trade with their customer orders. In addition, some specialists began paying broker-dealers to send them their customer orders, and sought greater guarantees that specialists could trade with these and other orders. In response to these pressures, member firms have been given increased opportunities (both by exchange rule and floor practice) to trade with (or internalize) the customer orders they bring to an exchange. While all of these practices were a response to greater competition between markets, they also raise structural issues because of their potential to decrease quote competition. As more customer orders are retained by a specialist or the firm that brought the order to the exchange, and therefore are unavailable to other members who are competing for orders based on price, these other members could have less incentive to compete by offering better prices on an exchange, and price competition may suffer. Eventually, if particular exchange members lock up too great a share of customer orders, the number of competing market makers within the market could diminish, and with them, active or potential intramarket price competition.

As a result, the disseminated quotations, and the prices available on a market, could deteriorate'ultimately harming investors. Moreover, because a firm can profit by internalizing its customers' orders while matching the best displayed quotes, rules that guarantee firms a right to trade with some or all of their own customers' orders may interfere with a broker-dealer seeking better prices that might be available in the market. For this reason, the Commission has closely scrutinized proposals by exchanges to guarantee specialists a proportion of orders traded on an exchange[161] and to guarantee that firms bringing their customers' orders to an exchange can trade with a certain proportion of those orders.

Several commenters express concern that the BOX proposal would encourage internalization[162] more than any other exchange[163] and would lead to a ''slippery slope'' or ''race to the bottom'' as other exchanges modify their market models to compete with BOX.[164] The Commission is keenly concerned about the issues raised by internalization in the options markets, and has been particularly vigilant with respect to proposed rule changes that would permit broker-dealers to internalize their customers' orders in a manner that could interfere with order interaction and discourage the display of aggressively-priced quotations. Indeed, the Commission is disinclined to approve not only those proposals by options exchanges that would guarantee broker-dealers the ability to internalize a significant portion of their own customers' orders, but also those proposed rule changes that would guarantee a large percentage of each customer order to *any* market participant. The Commission is concerned that such proposals may lock

[158] *Id.*

[159] *See* ISE Letter 2, *supra* note 10, at 6, 10.

[160] *See* proposed BOX Rules, Chapter VI, sec. 5(c)(iii)(1)(a); *see also* Amendment No. 4, *supra* note 11.

[161] All five existing options exchanges have rules that guarantee a specialist a proportion of each order when its quote is equal to the best price on the exchange. *See, e.g.,* Amex Rule 933(h); CBOE Rule 8.87; ISE Rule 713, Supplementary Material .01; Phlx Rule 1014(g), and PCX Rule 6.75(f)(4). These guarantees are special allocation provisions that differ from the general rules of the exchanges that assign executions based on priority, parity, nad precedence. Specialist guarantees reward market making firms willing to perform the obligations of a specialist by ensuring them that they will be able to interact as principal with a certain percentage of incoming orders. The Commission has generally found specialist guarantees to be consistent with the Act as a reasonable means for an exchange to attract and retain well-capitalized specialists that are responsible for assuring fair and orderly markets and fulfilling other responsibilities. The Commissioner has more closely scrutinized proposals, however, where the percentage of specialist participation would rise to a level that could have a material adverse impact on quote competition within a particular exchange. *See, e.g.,* Exchange Act Release No. 4311 (July 31, 2000), 65 FR 48778 (August 9, 2000) (Phlx's ''80/20'' proposal, which the exchange ultimately withdrew, would have increased its enhanced specialist participation to 80% for certain options orders) (''Phlx 80/20 Note''). In particular, the Commission is concerned that large specialist guarantees could significantly discourage intramarket price competition by ''locking up'' such a large proportion of each order that market makers in the crowd would be seriously hindered in their ability to compete with the specialist. Over the long-term, the decrease in intraexchange competition could widen spreads and diminish the quality of prices available to investors. *Id.*

[162] ''Internalization'' is generally known as the direction of order flow by a broker-dealer to an affiliated specialist or order flow executed by that broker-dealer as principal. *See* Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) at n.22 (File No. S7–30–95).

[163] *See* Amex Letter 3, *supra* note 10, at 2; CBOE Letter 2, *supra* note 10, at 1; ISE Letter 2, *supra* note 10, at 1; PCX Letter 2, *supra* note 10, at 2; and Phlx Letter 2, *supra* note 10, at 2.

[164] *See* CBOE Letter 2, *supra* note 10, at 2–3; ISE Letter 2, *supra* note 10, at 1–3, and PCX Letter 2, *supra* note 10, at 2.

away so much of each order that crowd members will no longer have an incentive to compete. To evaluate those comments contending that the BSE's proposal would encourage internalization more than existing options exchanges, it is necessary to first consider the level of internalization permitted on the other options exchanges.

As the options markets began to more aggressively list multiply list the most active options, the options exchanges adopted rules that allowed upstairs firms more rights to participate in certain customer orders they bring to the exchanges. For example, the ISE adopted a rule that permits upstairs firms to interact as principal with up to 40% of orders of 50 contracts or more that the firm presents to the exchange after an auction and other conditions are satisfied.[165]

In response to the ISE's ''facilitation'' rule, each of the other options exchanges adopted similar rules.[166] While certain provisions of the exchanges' facilitation guarantees vary,[167] to qualify for the guarantee all require the facilitation orders to be at least 50 contracts and the guarantee is limited to 40% of the contracts in each order. In addition, the options exchanges' rules permit a firm to trade with its own customer only after an auction in which other members of that market have an opportunity to participate in the trade at the proposed price or to improve the price. An auction prior to permitting a firm to internalize any portion of its customer's order gives some assurance that the price at which the trade takes place is the best price then available in the market. Moreover, if both a specialist and an upstairs firm would be entitled to a guarantee with respect to the same trade, the exchanges' rules do not permit the combined guarantee of the two firms to exceed 40% of the contracts to be traded, thereby allowing the trading crowd to compete for at least 60% of any order.[168] Of course, if members of the trading crowd are unwilling to trade with a particular order, the upstairs firm may internalize the entire order.

1. PIP Auction

The BOX Rules provide for an auction process, known as the PIP, which can be used by Options Participants seeking to execute their agency orders as principal. With certain exceptions, an Options Participant is not otherwise permitted to trade with its agency orders.[169] In addition, prior to submitting an order to the PIP, an OFP cannot inform an Options Participant or any other third party of any of the terms of the order, except as provided for in the BOX Rules regarding Directed Orders.[170]

The PIP features these key aspects:

- An Options Participant may submit any size Customer Order[171] for price improvement into the PIP, along with a matching contra order for the Options Participant's proprietary account at a price of at least one penny better than the prevailing NBBO at the commencement of the PIP (the ''Primary Improvement Order'').[172] The Primary Improvement Order may not be cancelled or modified, except by improving its price. Thus, the Customer Order is guaranteed an execution at a price at least one penny better than the NBBO.
- Market Makers assigned to the class, Options Participants with proprietary orders at the BOX inside bid or offer for the particular series (''PPOs''),[173] CPO[174] and the Options Participant who submitted the Primary Improvement Order may compete to trade with the Customer Order in one-penny increments during a three-second auction. These market participants can enter competing Improvement Orders[175] at penny increments to match or improve the price of the Primary Improvement Order. All other BOX Participants are informed of each PIP and may submit competing orders at standard price increments.
- The trade is allocated based on price and time priority at the end of the PIP, with certain exceptions. Specifically, Public Customer Orders and non-BOX Participant broker-dealer orders would have priority over any order of an OFP at the same price. In addition, Public Customer Orders would have priority over an unmodified Primary Improvement Order for the account of a Market Maker at the same price, and would have priority over a modified Primary Improvement Order for the account of a Market Maker that matches such Public Customer Orders.
- Because the execution of the Customer Order is guaranteed at the start of the PIP, the Customer Order has priority over all other orders on its side of the market that are entered on the BOX Book during the PIP.

The Commission finds that the PIP, as part of the BOX facility, is consistent with section 6(b)(5) of the Act. In general, the Commission believes that the proposed BOX Rules provide comparable limitations on internalization as the other exchange's rules that guarantee members the right to internalize their customers' orders. In particular, the BSE's proposal would require a firm to expose its customer order in the PIP before trading with that order.

As discussed below, the Commission believes that the three-second electronic auction proposed by the BSE should provide sufficient time for an electronic crowd to compete for a Customer Order. Moreover, the Commission believes that the access to the PIP by those who may wish to compete for a Customer Order is sufficient to provide opportunities for a meaningful, competitive auction. In fact, the Commission believes, as discussed below, that the BSE's proposal provides an opportunity for a

[165] *See* Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11388 (March 2, 2000) (Order approving registration of the ISE as a national securities exchange) (ISE Exchange Approval Release''). ISE's rules permit upstairs firms to enter orders of 50 contracts or more into the facilitation mechanism. Upon entry of an order into the facilitation mechanism, ISE sends a broadcast to crowd participants informing them of the proposed transaction, and the crowd is given ten seconds to respond. The upstairs firm entering the facilitation order will be allocated 40% of the original size of the facilitation order, but only after better-priced orders, quotes, and public customer orders at the facilitation price are executed. *See* ISE Rule 716(d).

[166] *See* Securities Exchange Act Release Nos. 42835 (May 26, 2000), 65 FR 35683 (June 5, 2000); 42848 (May 26, 2000), 65 FR 36206 (June 7, 2000); 42894 (June 2, 2000), 65 FR 36850 (June 12, 2000); and 47819 (May 8, 2003), 68 FR 25924 (May 14, 2003) (orders approving, respectively, File Nos. SR–CBOE–99–10; SR–PCX–99–18; SR–AMEX–99–36; and SR–PHLX–2002–17).

[167] For example, some of the exchanges' rules allow an upstairs firm to participate in an order even when it does not improve upon the price offered by the trading crowd. CBOE's Rule 6.74(d) is illustrative. If an upstairs firm chooses a facilitation price that matches the price offered by the trading crowd, the firm can participate in up to 20% of the facilitated order, whereas if it improves the trading crowd's price, its participation right rises to 40%. In either case, public customer orders must first be satisfied prior to the upstairs firm's participation in the facilitated order. *See* Exchange Act Release No. 42835, 65 FR 35683 (May 26, 2000) (order approving SR–CBOE–99–10).

[168] *See* Phlx 80/20 Notice, *supra* note , 65 FR at 48786.

[169] *See* infra notes 253–259—and accompanying text; proposed BOX Rules, Chapter V, sec. 17, Supplementary Material .03. *See* also Amendment No. 4, *supra* note 11.

[170] *See* proposed BOX Rules, Chapter V, sec. 17, Supplementary Material .04; see also Amendment No. 3, *supra* note 8.

[171] There would be no minimum size requirement for orders entered into the PIP, for a pilot period to extend eighteen months from the day trading commences on BOX. See proposed BOX Rules, Chapter V, sec. 18, Supplementary Material .01.

[172] *See* BOX Rules, Chapter V, sec. 18(e).

[173] *See* infra notes 199–201—and accompanying text.

[174] *See* infra notes 189–198—and accompanying text.

[175] An Improvement Order is any order entered by a Market Maker assigned to the class, a CPO, or a PPO priced at or better than the Options Participant's Primary Improvement Order. *See* proposed BOX Rules, Chapter V, sec.18(e)(i)–(ii).

greater number of market participants to compete in a PIP than current exchanges provide. The Commission believes that the only significant distinctions between the BSE's proposed PIP auction and the rules of other options exchanges that guarantee members the right to internalize customers' orders, is that orders of fewer than fifty contracts could be entered into the BOX PIP [176] and trades could take place in pennies,[177] whereas other exchanges' rules do not guarantee that members will be able to trade with such small-sized customer orders and require that trades all be in standard increments. The Commission discusses below the features of the BSE's proposal that it believes make these distinctions consistent with the Act.

a. Three Market Maker Requirement

There must be at least three Market Makers quoting in a relevant series at the time an Options Participant submits its Customer Order and Primary Improvement Order to initiate a PIP.[178] The Commission believes that this requirement will improve the opportunity for a Customer Order to be exposed to a competitive auction, and represents an improvement over current exchange auction rules. Specifically, current exchange rules that permit members to internalize their customers' orders do not require any market makers (other than a specialist) to be quoting in a series before a member trades with its customer.

b. Three-Second PIP

The BSE proposes that the duration of each PIP be 3 seconds, unless it concludes sooner due to the receipt on BOX of an unrelated order on the same side of the market as the Customer Order (such that it would cause an execution to occur).[179] In cases where an executable unrelated order on the same side as the Customer Order is submitted to BOX during a PIP, such that it would cause an execution to occur before the end of the three-second PIP, the PIP would conclude and the Customer Order would be matched with the Improvement Order(s) to the fullest extent possible.[180]

Some commenters criticize the proposed time period of the auction, arguing that the three-second PIP would favor highly capitalized firms with faster technology over smaller market participants.[181] Critics also argue that the three-second PIP would permit more internalization because orders are exposed to the market for only a very short period of time and many market participants, including CPOs, would be unable to assess their risks and market conditions in 3 seconds.[182] Another commenter contends that the PIP would afford the initiating Options Participant a ''last look'' to match the last price and take priority.[183]

The Commission believes that a three-second PIP should afford electronic crowds sufficient time to compete for Customer Orders submitted by an Options Participant. In reaching this conclusion, the Commission believes that the timeframes necessary for exposure and execution of orders be adjudged in light of the BOX market structure. The Commission believes that the critical issue is determining whether the three-second timeframe gives participants in a fully automated marketplace sufficient time to respond to a PIP broadcast to compete and provide price improvement for Customer Orders, and that electronic systems are available to BOX Options Participants that would allow them to respond to PIP broadcasts in a meaningful way within the proposed timeframe. The Commission notes that Market Makers and OFPs can either develop their own software to manage trading on BOX, or utilize one of the many front-end solutions that have been written to connect with electronic-based exchanges. All Options Participants should have the opportunity to develop or avail themselves of such systems, and although these automated systems will entail additional costs, the markets for derivative products are by their nature automation-intensive, and require a higher capital base than for other simpler financial products.

With respect to the comments that BSE's proposal would permit greater internalization due to the relatively short duration of the PIP, the Commission believes that the ability of Market Makers and other Options Participants on BOX to electronically monitor for PIP broadcasts, and to program competitive responses based on pre-set parameters, should provide a fair opportunity and incentive to compete for Customer Orders submitted to the PIP. Moreover, the Commission believes that one important difference between the BSE's proposed PIP and floor-based markets is that the BOX Options Participants do not know the identity of the Options Participant that submitted the Customer Order to the PIP. Accordingly, like the ISE's Facilitation Mechanism, the automated, non-personal nature of BOX's PIP provides no opportunity for agreements between the facilitating firm and the trading crowd whereby, for example, the trading crowd agrees not to break up a firm's proposed facilitation in exchange for that firm's agreement to bring order flow to the exchange.[184] Moreover, the PIP provides for price priority and competing Market Makers are entitled to an execution of some portion of the Customer Order even when the facilitating firm matches the Market Maker at the best quote at the conclusion of the PIP. In addition, the Options Participant who has submitted its Customer Order into the PIP does not have an opportunity for a ''last look'' to match the prices bid or offered during the PIP. The Commission believes that these features should limit internalization, while encouraging Options Participants to submit their most competitive orders/quotes first, before the PIP ends. Accordingly, the Commission believes that a three-second PIP is consistent with the Act.

c. Competition in the PIP

In addition to the Options Participant that submitted the Customer Order and Primary Improvement Order, all Market Makers assigned to a class would be permitted to compete in penny increments for orders in that class entered into a PIP.[185] Public Customers may also participate in a PIP through the use of CPOs.[186] In addition, Options Participants not assigned to a class as a Market Maker may submit PIP Proprietary Orders (''PPOs'') to compete for Customer Orders, if they meet certain requirements to submit a PPO.[187] Other market participants may submit orders to the BOX Book during the PIP. These ''unrelated orders'' would participate in a trade at the

[176] *See* Discussion *infra* at section II.E.1.g.

[177] *See* Discussion *infra* at section II.E.1.d.

[178] *See* proposed BOX Rules, Chapter V, sec. 18(e).

[179] *See* proposed BOX Rules, Chapter V, sec. 18(i). With respect to the same series, no PIP will run simultaneously with another PIP, nor will PIPs be permitted to queue or overlap in any manner. *See* proposed BOX Rules, sec. 18, Supplementary Material .02; *see also* Amendment No. 4, *supra* note 11.

[180] *See* proposed BOX Rules, Chapter V, sec. 18(i).

[181] *See* Phlx Letter 2, *supra* note 10, at 3; CBOE Letter 2, *supra* note 10, at 9.

[182] *See* Amex Letter 3, *supra* note 10, at 3; PCX Letter 2, *supra* note 10, at 3; and ISE Letter 2, *supra* note 10, at 5.

[183] *See* ISE Letter 1, *supra* note 7, at 6.

[184] *See* Securities Exchange Act Release No. 46514 (September 18, 2002), 67 FR 60267 (September 25, 2002).

[185] *See* proposed BOX Rules, Chapter V, sec. 18(e)(i).

[186] *See infra* notes 189–195 and accompanying text; proposed BOX Rules, Chapter V, sec. 18(g).

[187] *See infra* notes 199–201 and accompanying text; proposed BOX Rules, Chapter V, sec. 18(e)(i).

conclusion of the PIP at the standard minimum price increments.[188]

i. Customer PIP Order. Public Customers may participate in a PIP through the use of CPOs.[189] A CPO states a price in standard increments (five or 10 cents) at which the order would be placed on the BOX Book, as well as a price in pennies at which the Public Customer wishes to participate in any PIPs that might occur while its order is on the BOX Book (''CPO PIP Reference Price''). In addition, the terms of each CPO must include a specific order size (''CPO Total Size''). The number of contracts that may be entered into a PIP must be no greater than the lesser of (a) the CPO Total Size remaining on the BOX Book, or (b) the size of the Primary Improvement Order submitted to the PIP.[190] A CPO would be eligible to participate in a PIP, if the CPO is priced at or better than the best BOX price (''BOX BBO''),[191] and may participate in the PIP only on the same side of the market as the Primary Improvement Order. CPOs eligible to participate in a PIP may be submitted on behalf of Public Customers by OFPs. At any time during the PIP, the OFP may modify the price of the CPO submitted to the PIP to any price level up to the CPO PIP Reference Price.[192]

One commenter believes that the CPO procedures would not provide significant opportunities for Public Customer participation in PIP auctions because, while Market Makers would be able to decide at the time a PIP commences whether to compete, Public Customers would have to make that determination in advance.[193] The same commenter also criticizes the requirement that the CPO be on the BOX Book at the NBBO, while Market Makers have no similar requirement.[194] The Commission notes that in Amendment No. 4, the BSE proposes to change its proposed rules to permit a CPO to participate in a PIP when it is on the BOX Book at the BOX BBO, which would expand the opportunities for Public Customers to participate in the PIP. Moreover, the Commission believes that Public Customer access to the PIP is comparable to customers' access to open outcry auctions on the current floor-based exchange and potentially greater than their access to the ISE's Facilitation Mechanism. Specifically, customers must rely on floor brokers to represent any interest they may have in open outcry auctions. Also, the ISE does not currently broadcast notice of orders in its Facilitation Mechanism to members representing public customer orders, unless that member happens to have a proprietary order at the best ISE bid or offer, and permits customer orders to trade with orders in its Facilitation Mechanism if the customer order is displayed on the ISE at a price equal to or better than the facilitation price.[195]

Another commenter points out that the OFP may but is not required to submit a CPO to the PIP and surmised that, as a result, BOX could not guarantee customer access to the PIP.[196] Consequently, because many OFPs will not have technology to be able to submit CPOs to the PIP, the BOX trading system should be required to perform this function.[197] Alternatively, one commenter asserts that the BSE should require that OFPs be subject to a certification process, whereby they would demonstrate that they have the ability and capacity to support CPO order types.[198]

The Commission believes that permitting Public Customer Orders to participate in the PIP through the use of CPOs is an adequate means of Public Customer access to the PIP. The Commission also believes that an OFP need not be required to submit a CPO to the PIP. In this regard, the Commission notes that none of the current options exchanges' rules obligate their members to bring agency orders to an auction, but give them the discretion about how best to execute their customers' orders.

ii. PIP Proprietary Order (''PPO''). In response to concerns regarding access to the PIP auction, the BSE, in Amendment No. 4, proposes also to permit Options Participants to submit proprietary orders in penny increments into the PIP (''PPO''). Options Participants may enter a PPO for their proprietary accounts, provided that, at the commencement of the PIP, they already have a proprietary order or quote on the BOX Book at the inside bid or offer.[199] The size of the PPO must be no greater than the lesser of: (1) The total size remaining on the BOX Book for the proprietary order; or (2) the size of the Primary Improvement Order submitted to the PIP. At any time during the PIP, the Options Participant may improve the price of its PPO.[200]

The Commission believes that this change should allow for greater competition in the PIP auction and should, therefore, benefit Customers by providing them with greater opportunities for better prices. The Commission notes that the BSE's proposal is similar to the rules of other options exchanges, including the ISE's facilitation mechanism in which members with proprietary orders at the inside bid or offer for a particular series can participate in the facilitation mechanism.[201]

iii. Unrelated Orders. Under the BSE's proposal, unrelated orders could compete in standard increments to trade with the Customer Order in the PIP. Such unrelated orders could include agency orders on behalf of Public Customers, market makers on other exchanges, and non-BOX Options Participant broker-dealers, as well as non-PPO orders submitted by Options Participants.[202] Unrelated orders would be permitted to compete in the PIP only in standard increments.

d. Price Improvement in Penny Increments

As discussed above, during the PIP, Market Makers may submit Improvement Orders for those classes within their appointment. Improvement Orders would be submitted in penny increments and are valid only in the PIP process.

Several commenters argue that permitting penny increments in the PIP is likely to save the internalizing firm money while bringing little price improvement to customers. Specifically, commenters criticize the BSE proposal that an OFP would need to offer only penny price improvement in the PIP to internalize the order, while on other exchanges, the internalizing firm would have to offer improvement in standard

[188] An ''unrelated order'' is a non-Improvement Order entered into the BOX market during a PIP. *See infra* note 202 and accompanying text; proposed BOX Rules, Chapter V, sec. 18(e), (f), (g).

[189] *See* Amendment No. 3 Notice, *supra* note 9. One commenter objected to the original BOX Proposing Release, stating that the BSE discriminated among its Participants by not permitting Public Customers to participate in the PIP at penny increments. *See* CBOE Letter 1, *supra* note 7, at 5. In response to comments, the BSE proposed in Amendment No. 3 to introduce the CPO.

[190] *See* proposed BOX Rules, Chapter V, sec. 18(g)(ii); *see also* Amendment No. 4, *supra* note 11.

[191] In response to comments, the BSE changed its proposal to permit a CPO to participate in a PIP if the CPO is priced at or better than the BOX BBO, rather than the NBBO. *See* proposed BOX Rules, Chapter V, sec. 18(g)(iii); *see also* Amendment No. 4, *supra* note 11.

[192] *See* proposed BOX Rules, Chapter V, sec. 18(g)(v); *see also* Amendment No. 4, *supra* note 11.

[193] *See* ISE Letter 2, *supra* note 10, at 4.

[194] *Id.*

[195] *See* ISE Rule 716(d).

[196] *See* Amex Letter 3, *supra* note 10, at 4.

[197] *See* Amex Letter 3, *supra* note 10, at 4; ISE Letter 2, *supra* note 10, at 4–5.

[198] *See* PCX Letter 2, *supra* note 10, at Appendix at 5.

[199] *See* proposed BOX Rules, Chapter V, sec. 18(h); *see also* Amendment No. 4, *supra* note 11.

[200] *See* proposed BOX Rules, Chapter V, sec. 18(h)(iii); *see also* Amendment No. 4, *supra* note 11.

[201] *See* ISE Rule 716(d).

[202] *See* proposed BOX Rules, Chapter V, sec. 18(e)(iii); *see also* Amendment No. 4, *supra* note 11.

increments.[203] One of these commenters further predicts that all exchanges would have to quote in pennies to compete and OPRA may not be able to handle the increased message traffic that would result.[204]

The Commission believes that, because the PIP is designed to guarantee Customers a price at least a penny better than the NBBO, Customer Orders should benefit. At this point, the Commission has no reason to believe that the PIP auction would not be active and competitive.[205] BSE proposes relatively low barriers to Market Maker registration, as the fees are relatively low [206] and there are no limits on the number of qualifying entities that may become Market Makers.[207] In addition, execution in the PIP is, for the most part, based on price/time priority; thus, Market Makers would have an incentive to post their best prices quickly. Furthermore, the PIP is open to a wide variety of participants: BOX Market Makers assigned to the class, CPOs, and Options Participants with proprietary orders at the inside bid or offer. Also, the Commission notes that a firm can trade with its own customers' orders at the NBBO pursuant to the rules of the other options exchanges.

With respect to the commenter's prediction that Commission approval of the BOX market, with its PIP auction, would result in quoting in pennies by all markets, the Commission does not believe this to be a foregone conclusion. The PIP uses pennies in an auction, not in public quotations. Given the implications of penny quoting for OPRA, penny quoting would require very careful review by the Commission. Moreover, the approval of any proposed rule change is based upon the Commission's determination that the proposal is consistent with the Act, not that the proposal mimics one feature of the market structure of a competing exchange.

e. PIP Trade Allocation and Priority

At the conclusion of the PIP, the Customer Order would be matched against the best priced orders, whether Improvement Orders, or orders unrelated to the PIP that were received by BOX during the PIP process.[208] Orders would have priority at the same price based on time, with the following exceptions:

- The Options Participant who submitted the Customer Order into the PIP would have priority for 40% of the Customer Order, and would be allocated additional contracts only after all other competing orders have been filled at that price level.[209] Such Options Participant would yield this special priority under the following circumstances: (1) If such Options Participant were a Market Maker that had modified its Primary Improvement Order, it would yield this special priority to a Public Customer Order or an order of a non-BOX Participant broker-dealer that had time priority over the modified Primary Improvement Order; [210] (2) if such Options Participant were a Market Maker that had not modified its Primary Improvement Order (*i.e.,* at the initial PIP price level), would yield this special priority to a Public Customer Order or an order of a non-BOX Participant broker-dealer; [211] and (3) if such Options Participant were not a Market Maker, it would yield this special priority to a Public Customer Order or an order of a non-BOX Participant broker-dealer.[212]
- After the Options Participant who submitted the Customer Order to the PIP receives its allocation, a Market Maker designated as the Market Maker Prime [213] would have priority over all other Improvement Orders, including CPOs and PPOs, and unrelated orders up to one-third of the portion of the Customer Order remaining at that price level.[214] This special priority, however, would apply only if the Market Maker Prime enters an Improvement Order during the PIP.[215]
- All non-Market Maker Options Participants, including an Options Participant that submitted the Customer Order to the PIP, would yield priority to non-BOX member orders.[216]

i. Trade Participation Right. The Commission finds that the BSE's proposal to grant participation rights, under certain conditions, to the Options Participant that submitted a Customer Order to the PIP is reasonable and consistent with the Act. As discussed previously, the Commission is concerned that proposals by options exchanges that guarantee a significant portion of orders to any market participant could erode the incentive to display aggressively priced quotes.[217] Thus, the Commission must weigh whether the proposed participation right would so substantially reduce the ability of other market participants to trade with an order that it would reduce price competition. As the Commission has noted previously:

It is difficult to assess the precise level at which guarantees may begin to erode competitive market maker participation and potential price competition within a given market. In the future, after the Commission has studied the impact of guarantees, the Commission may need to reassess the level of these guarantees. For the immediate term, the Commission believes that 40% is not clearly inconsistent with the statutory standards of competition and free and open markets.[218]

The Commission believes that the BSE's proposal, which entitles (subject to certain exceptions) an Options Participant who submits the Primary Improvement Order to 40% of the Customer Order, is not inconsistent with the Act.[219] In addition, the

[203] *See* CBOE Letter 2, *supra* note 10, at 3–4; and PCX Letter 2, *supra* note 10, at 5.

[204] *See* CBOE Letter 2, *supra* note 10, at 7.

[205] The Commission notes that BSE would have no minimum size requirement for orders entered into the PIP, for at least a pilot period to extend 18 months from the day trading commences on BOX. *See* Section II.E.h. If the Commission believed that the PIP had eroded Market Maker incentives to quote competitively, the Commission has the ability not to extend the pilot period beyond the 18 months.

[206] *See* BOX Fee Approval, *supra* note 14.

[207] *But see supra* notes 28 and 45.

[208] Such unrelated orders may include agency orders on behalf of Public Customers, market makers at other exchanges, and non-BOX Participant broker-dealers, as well as non-PIP proprietary orders submitted by Options Participants. *See* proposed BOX Rules, Chapter V, sec. 18(e)(iii); *see also* Amendment No. 4, *supra* note 11.

[209] *See* proposed BOX Rules, Chapter V, sec. 18(f)(i).

[210] *See* proposed BOX Rules, Chapter V, sec. 18(f)(ii)(C).

[211] *See* proposed BOX Rules, Chapter V, sec. 18(f)(ii)(2); *see also* Amendment No. 4, *supra* note 11.

[212] *See* proposed BOX Rules, Chapter V, sec. 18(e)(iv) and 18(f)(ii)(1).

[213] A Market Maker Prime is a Market Maker who has a quote that is equal to the NBBO on the same side of the market as the Primary Improvement Order at the initiation of the PIP. If more than one Market Maker meets this criterion, the Market Maker whose quote has time priority would be the Market Maker Prime for that PIP. However, an Options Participant initiating a PIP on behalf of an agency order may not be the Market Maker Prime for that PIP. At the conclusion of that PIP, the Market Maker loses its status as Market Maker Prime. A Market Maker Prime would be determined each time a new PIP is initiated. *See* proposed BOX Rules, Chapter V, sec. 19.

[214] *See* proposed BOX Rules, Chapter V, sec. 19(b) and (c); *see also* Amendment No. 4, *supra* note 11.

[215] If the Market Maker Prime modifies its quote during the PIP to meet the best limit price instead of entering an Improvement Order into the PIP process, the Market Maker Prime allocation would not apply to the modified quote. Instead, the Market Maker Prime's modified quote would be treated as an unrelated order. *See* proposed BOX Rules, Chapter V, sec. 19(e).

[216] *See* proposed BOX Rules, Chapter V, sec. 18(e)(iv)(1) and 18 (f)(ii)(1).

[217] *See, e.g.,* Securities Exchange Act Release No. 43100 (July 31, 2000), 65 FR 48778 (August 9, 2000).

[218] *See* Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11388 (March 2, 2000) (order approving registration of the ISE as a national securities exchange).

[219] *See* proposed BOX Rules, Chapter V, sec. 19.

Commission notes that, except for BSE's proposal to permit orders of any size to be submitted to the PIP, the facilitation guarantee for the Options Participant bringing a Customer Order to the PIP is consistent with the facilitation guarantees in place at the existing options exchanges.[220] One commenter argues that the BSE should require its Options Participants to post the best price at which they are willing to trade against a Customer Order at the start of the PIP.[221] Although the BSE proposes to permit Market Makers to initiate a PIP and be eligible for the 40% guarantee without being at the BOX BBO at the time the PIP commences, this proposal is analogous to floor-based exchange rules that permit market makers to participate in open outcry auctions without quoting at the BBO before the order is presented to the crowd.[222]

The Commission believes that the BSE Rules should promote price competition within BOX by providing Options Participants with a reasonable opportunity to compete for a significant percentage of the incoming order and, therefore, should protect investors and the public interest. For the immediate term, the Commission continues to believe that a 40% allocation is consistent with the statutory standards for competition and free and open markets.

ii. Market Maker Prime The BSE's proposal would give priority to a Market Maker designated as a Market Maker Prime over other competing orders in the PIP. This priority is designed to provide an incentive for Market Makers to quote aggressively. A couple of commenters state that it is unfair that a Market Maker Prime has priority in the PIP, while CPOs also at the NBBO at the start of the PIP do not.[223] The Commission believes that the BSE's proposal to give priority to a Market Maker who quotes aggressively before a PIP is initiated, is consistent with the Act and may provide a further incentive for Market Makers to publicly display their best quotes, which would benefit all options market participants.

iii. Section 11(a) of the Act. Section 11(a) of the Exchange Act [224] prohibits a member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises discretion (collectively, ''covered accounts'') unless an exception applies. Transactions by dealers acting in the capacity of market makers, however, are excepted from these prohibitions.[225] Accordingly, the Commission believes that the BSE's proposal to give a Market Maker Prime priority over CPOs and other non-member broker-dealers is consistent with the Act. In addition, the Commission does not believe that section 11(a) requires other Market Makers to yield priority to non-members.

One commenter asserts that the lack of customer priority on BOX is inconsistent with section 11(a) of the Act with regard to OFPs.[226] This commenter argues that the BSE proposal is not consistent with section 11(a) because such Options Participants would not be required to yield priority to Public Customer Orders and non-BOX Participant broker-dealer orders in the PIP.[227]

In response to the commenter's concerns, the BSE proposes to amend its proposal to prohibit any orders for the accounts of non-Marker Maker Options Participants to be executed prior to the execution of Public Customer Orders, both CPO and unrelated Customer Orders, and non-BOX-Participant broker-dealer orders at the same price.[228] Section 11(a)(1)(G) and Rule 11a1–1(T) under the Act provide an exception to the general prohibition in section 11(a) on an exchange member effecting transactions for its own account. Specifically, a member that ''is primarily engaged in the business of underwriting and distributing securities issued by other persons, selling securities to customers, and acting as broker, or any one or more of such activities, and whose gross income normally is derived principally from such business and related activities'' [229] and effects a transaction in compliance with the requirements in Rule 11a1–1(T)(a) [230] may effect a transaction for its own account. Among other things, Rule 11a1–1(T)(a) requires that an exchange member presenting a bid or offer for its own account or the account of another member shall grant priority to any bid or offer at the same price for the account of a non-member of the exchange.[231] Because BSE's proposed rules would now require Options Participants that are not Market Makers to yield priority in the PIP to all non-member orders, the Commission believes that the proposal is consistent with the requirements in section 11(a) and Rule 11a1–1(T) under the Act. The Commission also reminds exchanges and their members that, in addition to yielding priority to non-member orders at the same price, members must also meet the other requirements under section 11(a)(1)(G) and Rule 11a1–1(T) (or satisfy the requirements of another exception) to effect transactions for their own accounts.[232]

iv. Section 11(b) of the Act. Section 11(b) of the Act [233] and Rule 11b–1 thereunder [234] permit national securities exchanges to, by rule, permit their members registered as specialists to act as both brokers and dealers, consistent with certain negative and affirmative obligations to maintain a fair and orderly market. Like the other options exchanges, BSE proposes to deem all of its Marker Makers to be specialists,[235] which provides a Marker Maker with certain benefits, such as the ability under Regulation M to continue to trade an option on a security when the market making firm is involved in the underwriting of the security underlying the option. However, as specialists, Marker Makers would be subject to section 11(b) under the Act [236] and Rule 11b–1 thereunder.[237]

One commenter asserts that the BSE's proposal to provide a BOX Marker Maker that submits a Directed Order to the PIP, and is at the best price at the conclusion of the PIP, with an allocation of 40% of the Directed Order ahead of Customer Orders at that price, would be inconsistent with a specialist's negative obligations as required by Rule 11b–1 under of the Act.[238]

[220] *See supra* note 161.

[221] *See* ISE Letter 2, *supra* note 10, at 3, 10–11.

[222] *See, e.g.*, CBOE Rules 6.43 and 8.50.

[223] *See* Amex Letter 3, *supra* note 10, at 4; PCX Letter 2, *supra* note 10, at 3–4.

[224] 15 U.S.C. 78k(a).

[225] 15 U.S.C. 78k(a)(1)(A).

[226] *See* Amex Letter 3, *supra* note 10, at 3; *see also* PCX Letter 2, *supra* note 10, at Appendix, at 8.

[227] *See* Amex Letter 3, *supra* note 10, at 3.

[228] See proposed BOX Rules, Chapter V, sec. 18(e)(iv) and (f)(ii)(1); *see also*, Amendment No. 4, supra note 11.

[229] 15 U.S.C. 78k(a)(1)(G)(i). Paragraph (b) of Rule 11a1–1(T) under the Act provides that the requirements of section 11(a)(1)(G)(i) of the Act if during its preceding fiscal year more than 50% of its gross revenues was derived from one or more of the sources specified in that section. In addition to any revenue which independently meets the requirements of section 11(a)(1)(G)(i), revenue derived from any transaction specified in paragraph (A), (B), or (D) of section 11(a)(1) of the Act or specified in Rule 11a1–4(T) shall be deemed to be revenue derived from one or more of the sources specified in section 11(a)(1)(G)(i).

[230] 15 U.S.C. 78k(a)(1)(G)(ii).

[231] 17 CFR 240.11a1–1(T)(a)(3).

[232] For a discussion of the application of section 11(a) of the Act to trades that take place on BOX other than through the PIP, *see* notes—and accompanying text.

[233] 15 U.S.C. 78k(b).

[234] 17 CFR 240.11b–1.

[235] *See* proposed BOX Rules, Chapter I, sec. 1(32).

[236] 15 U.S.C. 78k(b).

[237] 17 CFR 240.11b–1.

[238] *See* ISE Letter 2, *supra* note 10, at 15.

As described above, an OFP or Market Maker that submits a Customer Order to the PIP will be allocated 40% of that order, if at the end of the PIP, its Primary Improvement Order is at the best price and it was first in time at that price.[239] In response to the commenter's concern, the BSE proposes to modify its proposal to provide that a BOX Marker Maker that submitted an order to the PIP would yield priority, including its 40% allocation, to Public Customer Orders, unless the Market Maker modifies its Primary Improvement Order and has time priority over the Public Customer Order. The Commission believes it is appropriate for customer orders to have priority over a specialist's trade participation right,[240] and that such priority is consistent with section 11(b) of the Act. The Commission does not, however, believe that customers who may electronically generate orders must be accorded priority over market makers who are not acting as agent with respect to those customers.[241] BSE's proposal, as amended by Amendment No. 4, would give Public Customer Orders priority over a Market Maker who submitted a Directed Order to the PIP, if the trade took place at the initial price level. However, a Marker Maker submitting a Directed Order to the PIP would not be required to yield priority to Public Customer Orders if the Market Maker has time priority at subsequent price levels. Accordingly, the Commission finds that BSE's proposal is consistent with the Act.

f. Private Auction

Under the BSE's proposal, Customer Orders submitted to the PIP and the responding Improvement Orders would not be displayed or disseminated outside the BOX market. Several commenters argue that the PIP lacks transparency and amounts to a shadow or hidden market, in violation of the Commission's Quote Rule.[242] One commenter says that the disseminated quote from the BOX market would be meaningless, because the real market would be the non-public quoting in pennies in the PIP.[243] Under the Commission's Quote Rule, an exchange is required to collect, process, and make available to quotation vendors the best bids and offers that are communicated on the exchange.[244] The BSE proposes that Improvement Orders, including CPOs and PPOs, would be displayed to BOX Options Participants, but would not be disseminated to OPRA.[245] Commenters assert that the PIP would violate the Quote Rule because BSE proposes to limit the dissemination of Improvement Orders to BOX participants and to not make them available to quotation vendors.[246] The Commission believes that, for purposes of Quote Rule analysis, because the PIP is only three seconds in length, it is analogous to the open outcry auctions currently conducted on the floor-based exchanges, where auction prices are not widely disseminated and are available only for the order that initiated the auction and other orders in the crowd at that particular time. On the floor-based exchanges, a floor broker walks into a trading crowd and requests a market. The prices in the auction that then ensue are not disseminated outside of the floor and are not provided to other orders simultaneously executed at the disseminated quotation through the exchanges' automatic execution systems.

In addition, another commenter argues that the PIP would violate the Quote Rule[247] because unrelated Customer Orders on the same side of the market as the Customer Order being internalized would not trade with the liquidity in the PIP.[248] When an unrelated order concludes the PIP prior to the end of the three-second auction, the Customer Order submitted to the PIP is executed at the best price available in the PIP at that point in time. Neither an unrelated Customer Order at a better price on the same side of the market nor an unrelated BOX-Top Order on the same side of the market would be permitted to interact with Improvement Orders. The Commission does not agree that the proposed PIP would violate the Quote Rule. Instead, the Commission notes that the BOX proposal is consistent with the way in which the floor-based options exchanges operate today, where an incoming electronic order is automatically executed at the disseminated quote, even when an auction on the floor is underway at a better price. In addition, orders that are routed to the New York Stock Exchange (''NYSE'') through DirectPlus do not receive the benefit of any better prices available through the open outcry auction on the NYSE.

g. No Minimum Size Requirement for PIP

As stated above, the Commission believes that one of the principal differences between the BSE's proposed PIP and other exchanges' rules that guarantee members the right to trade with their customer orders is that the BOX PIP would be available for orders of fewer than 50 contracts. Under the BSE's proposal, BOX would have no minimum size requirement for orders entered into the PIP, for a pilot period to extend eighteen months from the day trading commences on BOX.

One commenter objects to the inclusion of orders of fewer than 50 contracts into the PIP,[249] because it would allow OFPs to internalize smaller customer orders, leaving only undesirable, unprofitable order flow for the regular auction, resulting in wider quotations overall.[250] The commenter asserts that small customer orders are the foundation for the auction pricing mechanism in the options market—*i.e.,* that Market Makers' posted prices take into account their ability to trade with these customer orders.[251] The commenter is therefore concerned that removing small customer orders from the public market could adversely affect the pricing mechanisms, because Market Makers on BOX and on other markets would be less willing to quote aggressively.[252]

The Commission believes, however, that the BSE's proposal provides small customer orders with benefits not available under the rules of other exchanges, and is consistent with the Act. In particular, any order entered into the PIP is guaranteed an execution at the end of the auction at a price at least a penny better than the NBBO. In addition, the Commission believes that BSE's proposal provides the opportunity for more market participants to compete. For example, the BSE has not limited the number of Market Makers assigned to each class, and would permit Public Customers and Options Participants that were not Market Makers to participate in the PIP through the use of CPOs and PPOs.

The Commission, however, understands the concern of commenters who fear that including orders of fewer than 50 contracts in the PIP may result in less competitive quotes. Therefore,

[239] *See* proposed BOX Rules, Chapter V, sec. 18(f)(i).

[240] *See* Securities Exchange Act Release No. 47628 (April 3, 2003), 68 FR 17697 (April 10, 2003) (Order approving CBOEdirect trading system).

[241] *Id.*

[242] *See* PCX Letter 2, *supra* note 10, at 2–3; Phlx Letter 2, *supra* note 10, at 4.

[243] *See* CBOE Letter 2, *supra* note 10, at 6.

[244] Rule 11Ac1–1(b)(1)(i) under the Act, 17 CFR 240.11Ac1–1(b)(1)(i).

[245] *See* proposed BOX Rules, Chapter V, sec. 18(j).

[246] *See* ISE Letter 2, *supra* note 10, at 5.

[247] 17 CFR 240.11Ac1–1.

[248] *See* CBOE Letter 2, *supra* note 10, at 8.

[249] *See* ISE Letter 1, *supra* note 7, at 7.

[250] *See* ISE Letter 2, *supra* note 10, at 1–2.

[251] *Id.* at 3.

[252] *Id.* at 3.

BSE has represented that it will provide the following information each month:

(1) The number of orders of fewer than 50 contracts entered into BOX's PIP, including the number of orders submitted by OFPs and the number of orders submitted by Market Makers;

(2) The percentage of all orders of fewer than 50 contracts sent to BOX that are entered into BOX's PIP;

(3) The percentage of all BOX trades represented by orders of fewer than 50 contracts;

(4) The percentage of all BOX trades effected through the PIP represented by orders of fewer than 50 contracts;

(5) The percentage of all contracts traded on BOX represented by orders of fewer than 50 contracts;

(6) The percentage of all contracts effected through the PIP represented by orders of fewer than 50 contracts;

(7) The spread in the option, at the time an order of fewer than 50 contracts is submitted to the PIP;

(8) Of PIP trades, the percentage done at the NBBO plus $.01, plus $.02, plus $.03, *etc.*;

(9) The number of orders submitted by OFPs when the spread was $.05, $.10, $.15, etc. For each spread, specify the percentage of contracts in orders of fewer than 50 contracts submitted to BOX's PIP that were traded by: (a) The OFP that submitted the order to the PIP; (b) BOX Market Makers assigned to the class; (c) PPOs (other BOX Participants who were at the BBO at the time the PIP started); (d) CPOs (customers at the BBO at the time the PIP started); and (e) unrelated orders (orders in standard increments entered during PIP); and

(10) The number of orders submitted by Market Makers when the spread was $.05, $.10, $.15, *etc.* For each spread, specify the percentage of contracts in orders of fewer than 50 contracts submitted to BOX's PIP that were traded by: (a) The Market Maker that submitted the order to the PIP; (b) BOX Market Makers assigned to the class, other than a Marker Maker who submitted the order to the PIP; (c) PPOs (other BOX Participants who were at the BBO at the time the PIP started); (d) CPOs (customers at the BBO at the time the PIP started); and (e) unrelated orders (orders in standard increments entered during PIP). The Commission will evaluate the PIP during the pilot period to determine whether it would be beneficial to customers and to the options market as a whole to approve any proposal requesting permanent approval to permit orders of fewer than 50 contracts to be submitted to the PIP.

2. Other BOX Rules to Limit Internalization Outside the PIP

The BOX Rules contain certain provisions restricting internalization by Options Participants outside of the PIP process, described below.[253] The Commission believes that the proposed rules regarding the limitations on principal transactions and solicited orders are consistent with the Act in that they should adequately protect against the internalization of Customer Order flow by a firm representing an order as agent.

a. Principal Transactions

The BSE proposes to limit an Options Participant's ability to trade as principal with an order it represents as agent, unless the order is first given the opportunity to interact with other trading interest on the Exchange. Specifically, OFPs may not execute as principal an order it represents as agent unless: (i) The agency order is first exposed on the BOX Book for at least 30 seconds; (ii) the OFP has been bidding or offering on BOX for at least 30 seconds prior to receiving an agency order that is executable against such bid or offer; or (iii) the OFP submits the agency order to the PIP, described above.[254] In addition, the BOX Rules would preclude an Options Participant from executing agency orders to increase its economic gain from trading with the order without first giving other trading interest on BOX an opportunity to trade with the agency order pursuant to the PIP rules. Specifically, it would be a violation of the BOX Rules for an Options Participant to provide an opportunity for a Customer to execute against agency orders handled by the Options Participant immediately upon their entry into the Trading Host.[255] The Commission believes that these restrictions on Options Participants trading as principal with orders they represent as agent, including the prohibition on doing indirectly what they are prohibited from doing directly, should protect against the internalization of order flow.

The BSE proposes to prohibit the disclosure of information about agency orders to third parties. Specifically, an Options Participant, prior to submitting an order to BOX, including submitting an order to the PIP, cannot disclose to another Options Participant or any other third party of any of the terms of the order, except as provided for in the Directed Order process.[256] The Commission believes that this rule should help to prevent Options Participants from doing indirectly what they are prohibited from doing directly, to prevent ''gaming.'' An Options Participant generally must expose orders it represents as agent before it may execute them as principal. Absent the prohibition on the disclosure of this type of information, an Options Participant and a third party could potentially use BOX to execute their orders with each other without exposing these orders to other trading interest. The Commission believes this rule will do much to prevent a firm from trading as principal with orders it represents as agent with a third party with whom it shares a beneficial interest.

b. Solicited Orders

The BSE proposes, in Amendment No. 4, to require Options Participants to expose orders they represent as agent on BOX for at least thirty seconds before such orders may be executed in whole or in part by orders solicited from other Options Participants and non-member broker-dealers to transact with such orders.[257] In addition, it would also be a violation of the BOX Rules for an Options Participant to cause the execution of an order it represents as agent on BOX by orders it solicited, if the Options Participant fails to expose those orders on BOX as required above.[258] As with Options Participant principal transactions, the purpose of the order exposure requirement is to assure that agency orders have an opportunity to interact on BOX before they are executed either by the broker representing the order or by another order solicited by the broker.

F. Application of the ''Effect versus Execute'' Exemption From Section 11(a) of the Act

Section 11(a) of the Exchange Act[259] prohibits a member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises discretion (collectively,

[253] *See* Amendment No. 4, *supra* note 11.

[254] *See* proposed BOX Rules, Chapter V, sec. 17, Supplementary Material .03; *see also* Amendment No. 4, *supra* note 11. The proposed BOX Rule is substantially similar to ISE Rule 717(d).

[255] *See* proposed BOX Rules, Chapter V, sec. 17, Supplementary Material .01. This interpretation is substantially similar to ISE Rule 717, Supplemental Material .01.

[256] *See* proposed BOX Rules, Chapter V, sec. 17, Supplementary Material .04. This provision is comparable to ISE Rule 400, Supplemental Material .01.

[257] *See* proposed BOX Rules, Chapter V, sec. 17, Supplementary Material .02; *see also* Amendment No. 4, *supra* note 11.

[258] *Id.*

[259] 15 U.S.C. 78k(a).

''covered accounts'') unless an exception applies. In addition to the exceptions set forth in the statute, Rule 11a2–2(T) [260] provides exchange members with an exemption from this prohibition. Known as the ''effect versus execute'' rule, Rule 11a2–2(T) permits an exchange member, subject to certain conditions, to effect transactions for covered accounts by arranging for an unaffiliated member to execute the transactions on the exchange. To comply with the rule's conditions, a member (i) must transmit the order from off the exchange floor; (ii) may not participate in the execution of the transaction once it has been transmitted to the member performing the execution; [261] (iii) may not be affiliated with the executing member; and (iv) with respect to an account over which the member has investment discretion, neither the member nor its associated person may retain any compensation in the connection with effecting the transaction except as provided in the Rule.

In Amendment No. 4, the BSE represents that transactions effected on BOX, excluding those transactions effected through the PIP process, satisfy the conditions of Rule 11a2–2(T). Based on these representations, the Commission finds that the order execution algorithm of BOX complies with the requirements of section 11(a) of the Exchange and Rule 11a2–2(T) thereunder.

In particular, the BSE states that ''BOX will place all of its participants on the 'same footing' '' and that ''no participant will enjoy any special control over the timing of execution or special order handling advantages, as all orders will be centrally processed for execution by computer.'' Specifically, orders sent to BOX will be transmitted from remote terminals directly to the system by electronic means. Once an order is submitted to BOX, the order is executed against another order based on an established matching algorithm. As the BSE explains, the execution does not depend on the Options Participant but rather upon what other orders are entered into BOX at or around the same time as the subject order, what orders are on the BOX Book and where the order is ranked based on the strict price-time priority ranking algorithm. Accordingly, Options Participants do not control or influence the result or timing of orders submitted to BOX.

Based on these representations, the Commission finds that BOX's electronic order submission and execution process satisfies the four conditions of Rule 11a2–2(T).[262] First, all orders are electronically submitted through remote terminals. Second, because a member relinquishes control of its order after it is submitted to BOX, the member does not receive special or unique trading advantages. Third, although the rule contemplates having an order executed by an exchange member who is not affiliated with the member initiating the order, the Commission recognizes that this requirement is satisfied when automated exchange facilities are used.[263] Fourth, the BSE states that BOX Options Participants that rely on Rule 11a2–2(T) for a managed account transaction must comply with the limitations on compensation set forth in the rule.

G. Best Execution of Customer Limit Orders

As discussed above, customer Limit Orders would not have priority over professional trading interest in the BOX market. Thus, if a broker-dealer sends a non-marketable Public Customer Limit Order to BOX, and professional trading interest already is on the book at the same price, the professional interest would have priority. One commenter notes that, in contrast, if the broker-dealer sends that Public Customer Order to any other options exchange, the Public Customer would have priority over any pre-existing professional interest on the book.[264] Because a broker-dealer would be aware of this difference when it makes its order-routing decisions, this commenter contends that a broker-dealer would violate its best execution responsibility to its customers any time the broker-dealer sends a customer order to BOX without first confirming that there is no professional orders on the BOX book at the same price.[265]

The Commission disagrees that a broker sending its customer orders to BOX would be *per se* violating its best execution obligation. The Commission has long held the view that in satisfying its duty of best execution,[266] which requires a broker to seek the most favorable terms reasonably available under the circumstances for a customer's transaction, a broker must periodically assess the quality of competing markets to assure that order flow is directed to markets providing the most beneficial terms for their customers' orders.[267] Moreover, the contention that all existing options exchanges provide strict customer priority is an overstatement. In fact, several options exchanges currently have rules that permit market makers to be on parity with customer orders in certain circumstances.[268] The Commission continues to believe that best execution requires the broker, in evaluating its procedures for handling customer orders, to take into account any material differences in execution quality among the various markets to which such orders may be routed.[269] These differences could arise from different priority rules, as the commenter suggests, or from a different frequency of execution. If a market gave less preferential treatment to customer orders, yet customer orders still received faster executions at comparable prices in that market, a broker could conclude that that market offered the possibility of best execution. Of course, a broker could not, consistent with its best execution obligations, permit the

[260] 17 CFR 240.11a2–2(T).

[261] The member, however, may participate in clearing and settling the transaction.

[262] The Commission and its staff, on numerous occasions, have considered the application of Rule 11a2–2(T) to electronic trading and order routing systems. *See, e.g.*, Securities Exchange Act Release Nos. 44983 (October 25, 2001) (Order approving the Archipelago Exchange as the equities trading facility of PCX Equities Inc.); and 29237 (May 31, 1991) (regarding NYSE's Off-Hours Trading Facility); 15533 (January 29, 1979) (regarding the Amex Post Execution Reporting System, the Amex Switching System, the Intermarket Trading System, the Multiple Dealer Trading Facility of the Cincinnati Stock Exchange, the PCX's Communications and Execution System, and the Phlx's Automated Communications and Execution System); and 14563 (March 14, 1978) (regarding the NYSE's Designated Order Turnaround System). *See also* Letter from Larry E. Bergmann, Senior Associate Director, Division, SEC to Edith Hallahan, Associate General Counsel, Phlx (March 24, 1999) (regarding Phlx's VWAP Trading System); letter from Catherine McGuire, Chief Counsel, Division, SEC, to David E. Rosedahl, PCX (November 30, 1998) (regarding Optimark); and Letter from Brandon Becker, Director, Division, SEC, to George T. Simon, Foley & Lardner (November 30, 1994) (regarding Chicago Match).

[263] In considering the operation of automated execution systems operated by an exchange, the Commission noted that while there is no independent executing exchange member, the execution of an order is automatic once it has been transmitted into the systems. Because the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange, the Commission has stated that executions obtained through these systems satisfy the independent execution requirement of Rule 11a2–2(T). *See* Securities Exchange Act Release No. 15533 (January 29, 1979).

[264] *See* ISE Letter 2, *supra* note 10, at 11–12.

[265] *Id.*

[266] A broker-dealer's duty of best execution derives from common law agency principals and fiduciary obligations and is incorporated both in SRO rules, and through judicial and Commission decisions, in the antifraud provisions of the federal securities laws. *See* Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) (''Order Handling Rules Release''), n.348 and accompanying text.

[267] Order Handling Rules Release, *supra* note 266.

[268] *See* Amex Rule 111, Commentary .07 and Phlx Rule 1014(d)(ii); *see also* CBOE Rule 43.1.

[269] Order Handling Rules Release, *supra* note .

opportunity either to internalize a portion of its customer order or to obtain payment-for-order flow to color its view of the execution quality afforded its customer orders.

The same commenter noted that when an Options Participant initiates a PIP, it does not have to initiate the PIP at the best price it is willing to trade. Instead, the Options Participant may improve the price it is willing to offer its customer during the three-second auction in response to higher prices offered by others. The commenter argues that this is a clear violation of an Options Participant's fiduciary obligations, because an Options Participant who does not put forward its best price in initiating a PIP auction would not provide the best opportunity for price improvement to its customer. This commenter believes that there is a similar violation of fiduciary obligations when an OFP directs the order to a preferenced Marker Maker.[270]

The Commission does not agree with the commenter's assertion that that an Options Participant's duty of best execution requires the Options Participant to submit its best price when initiating a PIP. The Primary Improvement Order is entered into the PIP at the guaranteed price, which, by definition, is at least one penny better than the best price available on any other options exchange at that time. The OFP or Marker Maker guarantees to execute its Customer's order at this price and ensures that the Customer will receive an execution at a price no worse, and possibly better, than the guaranteed price. After the order is guaranteed, the three-second auction begins. At that point, all those entitled to participate in the PIP have an equal opportunity to match or improve the guaranteed price. The OFP or Marker Maker that initiated the PIP will receive its 40% guarantee only if it is at the best price at the conclusion of the PIP auction.

Moreover, the vast majority of customer orders are executed at the disseminated NBBO in automatic execution systems on each of the floor-based options exchanges, which do not provide any opportunity for price improvement. Despite the fact that if such orders were instead directed to the exchange floors, such orders might receive price improvement, the Commission has never taken the position that best execution requires that brokers bring each and every customer order to the floor of the exchanges for the possibility of price improvement over the disseminated NBBO.

The proposed BOX Rules also contain a number of requirements to guide Options Participants that facilitate customer orders as principal towards fulfilling their best execution duty to their customers. These rules supplement the broker's best execution obligation. For example, Options Participants must ensure that when executing a Customer Order in the PIP, they act with due skill, care, and diligence, and that the interests of their Customers are not prejudiced.[271] Further, an Options Participant must not use the PIP to create a misleading impression of market activity.[272]

In addition, certain features of the BOX PIP help ensure that Options Participants comply with their duty of best execution. For example, no Options Participant is permitted to cancel or to modify the size of its Primary Improvement Order or the Customer Order at any time during the PIP, and the Options Participant may modify the price of its Primary Improvement Order only by improving it.[273]

H. Linkage Plan Rules

BSE represents that it intends to participate in the Options Intermarket Linkage Plan (''Linkage Plan.''). In order to do so, BSE would be required to comply with the obligations of Participants under the Linkage Plan and, therefore, proposes certain rules relating to the Linkage as part of the proposed BOX Rules.[274] These proposed rules are substantially similar to the rules in place on all of the options exchanges that are Participant to the Linkage Plan.[275]

In general, the proposed BOX Rules contain relevant definitions, establish the conditions pursuant to which Market Makers may enter Linkage orders, impose obligations on the Exchange regarding how it must process incoming Linkage orders, and establish a general standard that Options Participants should avoid trade-throughs. The proposed BOX Rules establish potential regulatory liability for Options Participants who engage in a pattern or practice of trading through other exchanges, establish obligations with respect to locked and crossed markets, and restrict a market maker on an Exchange from sending principal orders (other than P/A orders, which reflect unexecuted customer orders) through the Linkage if the market maker affects less than 80 percent of specified order flow on the Exchange.

In addition to these Linkage Rules, as part of its proposed trading rules, BSE proposes several rules that affect order handling through the linkage. Further, certain of the BOX Linkage Rules are unique to BOX and thus warrant further description.

1. Role of the BOX InterMarket Linkage Market Market and Eligible Market Makers

In Amendment No. 3 to the proposed rule change, BSE proposed rules that were intended to bring the BOX Rules into conformity with the requirements of the Linkage Plan so that BSE would be eligible to become a Participant in the Linkage Plan. Under the Linkage Plan, an ''Eligible Market Maker,'' defined as, among other things, a market maker who is assigned to, and provides two-sided quotations in an option class eligible for trading through the Linkage,[276] undertakes several agency responsibilities, including the handling of P/A orders and Satisfaction (''S'') orders if a trade-through has occurred.[277]

Two commenters express concern that the BOX's order handling process would be inconsistent with the Linkage Plan because it would permit BOX Market Makers to send orders through the Linkage with the agency responsibilities that the Linkage Plan requires for Eligible Market Makers.[278] The commenters note that it would be the BOX System and not an Eligible Market Maker who would handle certain aspects of the P/A order and S order process.[279] Another commenter states that the proposal did not address how BSE would determine which BOX Market Maker would be designated as the BOX Eligible Market Maker for each Eligible Options Class.[280]

To ensure that there is an Eligible Market Maker per Eligible Class (as those terms are defined in the Linkage

[270] *See* ISE Letter 2, *supra* note 10, at 10–11.

[271] *See* proposed BOX Rules, Chapter V, sec. 18(b).

[272] *See* proposed BOX Rules, Chapter V, sec. 18(d).

[273] *See* proposed BOX Rules, Chapter V, sec. 18(e)(ii). The ISE's Supplementary Material to ISE Rule 716 states that it will be violation of a member's duty of best execution to its customer if it were to cancel a facilitation order to avoid execution of the order at a better price. The BOX PIP goes one step further by prohibiting cancellation of the OFP's facilitation order.

[274] *See* proposed BOX Rules, Chapter XII, secs. 1–6.

[275] *See* Amex Rules 940–945, CBOE Rules 6.80–6.85, ISE Rules 1900–1905, PCX Rules 6.92–6.96, and Phlx Rules 1083–87.

[276] *See* section 2(7) of the Linkage Plan.

[277] *See* section 7(a)(ii) of the Linkage Plan.

[278] *See* ISE Letter 2, *supra* note 10, at 13; and PCX Letter 2, *supra* note 10, at 7; *See also* section 2(16)(a) (defining ''P/A Order''), section 7(a)(ii) of the Plan (providing that market makers may send P/A Orders through Linkage).

[279] *See* ISE Letter 2, *supra* note 10, at 13; and PCX Letter 2, *supra* note 10, at 7.

[280] *See* Amex Letter 3, *supra* note 10, at 6.

Plan and the proposed BOX Rules) for the submission of P/A and S orders to away markets, and in response to commenters' concerns, in Amendment No. 4, the BSE proposes to amend its rules to specifically define a BOX InterMarket Linkage Market Maker (''BIMM'') as the BOX Eligible Market Maker (''BEMM'') designated with the responsibility for settling P/A and S orders that would be sent to away markets through the Linkage for a given class on BOX.[281] A BIMM responsible for such orders would be specifically designated in each Eligible Class traded on BOX. The BIMM would adhere to the responsibilities of an Eligible Market Maker, as set forth in the Linkage Plan.

Further, the BIMM would be required to act with due diligence with regard to the interests of orders entrusted to it and fulfill other duties of an agent, including, but not limited to, ensuring that such orders, regardless of their size or source, receive proper representation and timely execution in accordance with the terms of the orders and the rules of the Exchange. To enable the BIMM to carry out its agency responsibilities with respect to P/A orders submitted through the Linkage, the BSE would require that a BIMM submit prior written instructions to BOX regarding the routing of any P/A orders that the Market Maker would send through the Linkage. BOX would immediately route all P/A orders on behalf of the Market Maker according to these instructions. The order would be generated automatically by BOX and routed to the away exchange with the required BIMM clearing and valid-clearing-firm (''VCF'') information included. Each execution received from an away exchange would result in the automatic generation of a trade execution on BOX between the original Public Customer Order and the BIMM.

The addition of a BIMM should ensure that a Market Maker on BOX is ultimately responsible for decisions regarding the routing of P/A and S orders and exercises appropriate discretion over such orders. While BOX may carry out the mechanics of routing such orders, a BIMM will be responsible for providing BOX with instructions on how and where to route order. Further, all P/A orders routed from BOX will carry a BIMM's clearing and VCF information and any execution received from an away exchange will result in a trade execution on BOX between the original Public Customer Order and the BIMM. The Commission believes that the proposed use of a BIMM addresses the concerns of commenters and should ensure that P/A and S orders will be handled in accordance with the Linkage Plan.

2. Use of the Trade-Through Filter

As discussed above, under the proposed BOX Rules, all in-bound agency orders received by BOX, including P orders and P/A orders, would be checked against the NBBO using BOX's trade-through filter mechanism as set forth in Chapter V, section 16(b).[282] Accordingly, the Trading Host would not permit the execution of an order submitted by an Options Participant on behalf of a Public Customer or broker-dealer that is not registered with BOX as an Options Participant, as well as an incoming P or P/A Order, unless BOX was disseminating the NBBO.

As proposed in Amendment No. 3, if BOX were not quoting at the NBBO, an incoming P or P/A Order would be exposed on the BOX Book for three seconds at the NBBO price, during which time any Options Participant would be able to execute against the order. At the end of this three-second period, if the order were not fully executed and a better price existed at an away exchange(s), a P/A order would be generated automatically by the BOX, and routed to the away exchange. In the event that BOX was no longer quoting at the best price when it received the P or P/A Order, the BSE proposed that these orders also would be processed through the filter. Any unexecuted quantity that remained on the book after the three-second exposure period would be returned to the originating exchange.

Commenters express concern that BSE's proposal to expose incoming P and P/A orders from away markets to the three-second exposure when BOX was no longer disseminating the NBBO would be inconsistent with the Linkage Plan[283] and would permit BOX Options Participants an impermissible ''second-look'' at incoming Linkage Orders when BOX was no longer quoting at the best price.[284]

BSE responded to commenters' concerns in Amendment No. 4 by proposing to amend its proposed rules to exclude incoming P and P/A Orders from exposure for three seconds when BOX was no longer disseminating the NBBO at the time it receives an incoming P or P/A Order.[285] Therefore, in the event that BOX is no longer quoting at the Linkage Reference Price, as that term is defined in the Linkage Plan, at the time it receives a P or P/A order from an away market, BOX would immediately reject the order. The Commission believes that these provisions, which require BOX to immediately reject a P or P/A order in the event that BOX is no longer quoting at the Reference Price, are appropriate and should ensure that these orders are handled in compliance with the Linkage Plan.

The Commission believes that the proposed use of the filter for agency orders submitted by a BOX Participant should provide an effective means for avoiding trade-throughs.[286] The filter should ensure that in the event that BOX is not quoting at the best price, a P/A order is automatically generated and routed in accordance with instructions from the responsible BIMM, or the order is rejected. The Linkage Plan requires that, absent reasonable justification and during normal market conditions, exchange members should not effect trade-throughs.[287] In addition, Chapter XII, section 3(a) of the BOX Rules would require members to avoid initiating trade-throughs when purchasing or selling either as principal or agent, any options series. Accordingly, the Commission believes that BOX Participants must avoid initiating trade-throughs when they effect transactions for their own accounts, as well as when they submit agency orders. Therefore, the Commission believes that there is nothing in the BOX Rules that is inconsistent with the Linkage Plan. Nevertheless, the Commission's approval of the proposed rule change will not be effective until the BSE can demonstrate to the Commission staff that BOX Options Participants can comply with the trade-through requirements of the Linkage Plan with regard to all trades effected through BOX or any exemption from such Linkage Plan requirements.

Another commenter questions why BOX proposes to expose the unexecuted portion of incoming P orders to BOX

[281] *See* proposed BOX Rules, Chapter VI, sec. 5(a)(ix).

[282] *See supra* notes 124–137—and accompanying text.

[283] *See* section 2(16) of the Linkage Plan (defining ''Linkage Order'').

[284] *See* Phlx Letter 2, *supra* note 10, at 5–6 and ISE Letter 2, *supra* note 10, at 14 (*citing* section 7(a)(ii)(A) of the Linkage Plan, providing that an exchange receiving a P/A order must execute the P/A Order in its automatic execution system, if available, if its disseminated quotation is equal to or better than the Reference Price when that order arrives. The ISE argues that implicit in this requirement is that the receiving exchange reject the order if it is not then at the NBBO). *See also* section 7(a)(ii)(C) of the Linkage Plan (providing similar obligations for Eligible Market Makers who receive P Orders).

[285] *See* proposed BOX Rules, Chapter V, sec. 16(b)(iii)(2)(b).

[286] *See supra* note 124.

[287] *See* section 8(c) of the Linkage Plan.

Options Participants for only three seconds, when the Linkage Plan and another part of BOX's proposed rules provide BOX Options Participants 15 seconds to respond to incoming P and P/A orders larger than the Firm Principal Quote Size or the Firm Customer Quote size, respectively.[288]

The Linkage Plan permits Linkage Orders that are larger than the Firm Principal Quote Size or the Firm Customer Quote Size to be handled outside of the automatic execution systems of the Linkage Participants and and provides Participants with up to 15 seconds to reply to a sending Participant.[289] Therefore, the Commission believes that the BOX's proposal to expose the unexecuted portion of any P or P/A orders that are larger than the Firm Principal Quote Size or Firm Customer Quote Size for only three seconds is consistent with the Linkage Plan.

3. PIP and Trade-Throughs

As described in more detail above, the proposed BOX Rules provide for a PIP during which an OFP or Market Maker may submit a Customer Order for price improvement at a price of at least one cent better than the prevailing NBBO. Upon entering the Customer Order into the PIP, the OFP or Market Maker ''guarantees'' the Customer Order at that better price. Thus, the Customer Order is guaranteed at the end of the PIP an execution of at least one penny better than the NBBO was at the commencement of the PIP.

One commenter argues that use of the PIP may result in a pattern or practice of trade-throughs in violation of the Linkage Plan [290] if the NBBO moves to a price more favorable to the Customer Order during the PIP.[291] The Commission disagrees with this commenter that use of the PIP would result in a pattern or practice of trade-throughs in the scenario that that commenter describes. Because the BSE proposes to require that a Customer Order be ''guaranteed'' at a better price than the NBBO at the initiation of the PIP, the Commission believes that the trade should be considered to have occurred at the time the order is provided the guarantee.[292] Accordingly, the Commission does not believe that it should be considered a trade-through if a trade is executed through the PIP at a price that is better than the NBBO at the commencement of the PIP, but—because of a change in the NBBO—inferior to the NBBO at the conclusion of the PIP. The Commission reminds brokers, however, that they must always consider their best execution obligations.

Finally, two commenters also contend that the PIP would result in trade-throughs because orders on the BOX Book would not be able to trade against the price at which a CPO is willing to buy or sell in a PIP, the CPO PIP Reference Price.[293] Similarly, one commenter questions how a BIMM would handle a Satisfaction Order that it receives as a result of its execution of a block-size order in penny increments at a price inferior to the NBBO given that other Linkage Participants only trade at minimum price increments of $.05 or $.10.[294] Under the Linkage Plan, when an Exchange executes a ''block trade'' of 500 contracts at a price that trades through a price on another exchange, the other exchange can submit through the Linkage a Satisfaction Order at the price of the block trade.[295] The commenter believes that if the block order execution occurred between intervals of $.05 (*i.e.*, $1.17, $1.18, etc.), an exchange whose system cannot format Satisfaction Orders in penny increments would not be able to use the Linkage to send the Satisfaction Order.

The Commission notes that only orders executed during BOX's PIP may be priced in penny increments and that the OFP who represents the CPO would be the only Options Participant aware of the price at which a CPO is willing to buy or sell (the CPO PIP Reference Price.) As described above, all orders executed in the PIP are ''guaranteed'' at a better price than the NBBO at the initiation of the PIP.

Because the CPO PIP Reference Price is not a displayed interest, the requirement to avoid trading through that price would not apply. The Commission believes that the trade should be considered to have occurred at the time the order is guaranteed at a price at least a penny better than the NBBO. Accordingly, the Commission believes that no trade-through could result from an execution during a PIP. Therefore, the Commission finds that BSE's proposed PIP is appropriate and is consistent with the Linkage Plan.

4. BOX-Top Orders and Locked and Crossed Markets

As described above, BSE proposes to have ''BOX-Top Orders'' in lieu of market orders. BOX-Top Orders entered into the BOX Book are executed at the best price available in the BOX market for the total quantity available from any contra bid (offer). Any residual volume would be automatically converted to a Limit Order at the price at which part of the original BOX-Top Order was executed.

One commenter states that the process of automatically converting the unexecuted portion of a BOX-Top Order into a Limit Order is inconsistent with the Linkage Plan because the unexecuted remaining portion of a BOX-Top Order could lock or cross other markets, which the Linkage Plan requires Participants to avoid.[296]

The commenter correctly states that the Linkage Plan provides that dissemination of locked or crossed markets shall be avoided.[297] The Commission, however, does not believe that the process proposed by BSE for converting the unexecuted portion of a BOX-Top Order into a Limit Order would result in locked or crossed markets. In making this determination, the Commission notes that before any portion of a BOX-Top Order is placed on the BOX book following a partial execution at the market price, the remainder of the order would be processed through the BOX filter.[298] The filter would expose the remainder of the order for three seconds at the NBBO for execution. If there were any unexecuted quantity at the end of the three seconds, this quantity would be sent as a P/A Order to the away market displaying the NBBO if the order is marketable at the NBBO displayed by another market. If the order cannot be routed to another exchange for execution because the limit price is better than the NBBO, the unexecuted quantity would then be booked at the limit price. The Commission believes that this process should ensure that BOX-Top Orders would not result in locked or crossed market in violation of the Linkage Plan.

I. Rule 17d–2 Agreements

Section 17 of the Act [299] and Rule 17d–2 thereunder [300] permit SROs,

[288] *See* Amex Letter 3, *supra* note 10, at p. 6. *Compare* proposed BOX Rules, Chapter V, sec. 16(b)(iii)(2) (describing the BOX filtering mechanism) *to* sections 7(a)(ii)(B) and 7(a)(ii)(C) of the Linkage Plan and proposed BOX Rules, Chapter XII, sec. 2(f).

[289] *See* section 7(a)(ii)(B)(1) of the Linkage Plan.

[290] *See* section 8(c)(i)(C) of the Linkage Plan.

[291] *See* CBOE Letter 2, *supra* note 10, at 9.

[292] *See* Division of Market Regulation, Staff Legal Bulletin 12R, ''Frequently Asked Questions About Rule 11Ac1–5,'' June 22, 2001.

[293] *See* CBOE Letter 2, *supra* note 10, at 8, and Amex Letter 3, *supra* note 10, at 4.

[294] *See* PCX Letter 2, *supra* note 10, Appendix at 13.

[295] *See* sections 8(c)(ii)(B)(1) and 2(26) of the Linkage Plan.

[296] *See* Phlx Letter 2, *supra* note 10, at 5.

[297] *See* section 7(a)(i)(C) of the Linkage Plan.

[298] *See* Discussion section II.C., *supra.*

[299] 15 U.S.C. 78q.

[300] 17 CFR 240.17d–2.

through so-called Rule 17d–2 agreements, to allocate certain regulatory responsibilities. Specifically, Rule 17d–2 under the Act [301] permits SROs to file with the Commission plans under which the SROs allocate among each other the responsibility to receive regulatory reports from, and examine and enforce compliance with specified provisions of the Act and rules thereunder and SRO rules by firms that are members of more than one SRO (''common members''). If such a plan is declared effective by the Commission, an SRO that is a party to the plan is relieved of regulatory responsibility as to any common member for whom responsibility is allocated under the plan to another SRO. These agreements help to avoid duplicative oversight and regulation. In this regard, the Commission approved a 17d–2 agreement (''Agreement'') among the Amex, CBOE, ISE, the National Association of Securities Dealers, the NYSE, PCX, and Phlx that allocates the regulatory responsibilities among these SROs for common members relating to the conduct of broker-dealers of accounts for listed options or index warrants.[302]

The BSE plans to become a participant in this Agreement. Under this Agreement, the examining SROs will examine firms that are common members of the BSE and the particular examining SRO for compliance with certain provisions of the Act, certain of the rules and regulations adopted thereunder, certain examining SRO rules, and certain BOX Rules. In addition, the BOX Rules contemplate participation in this Agreement by requiring that any OFP be a member of at least one of the examining SROs.[303] Accordingly, the Commission's approval of the BSE's proposed rule change will not be effective until the BSE enters into the Agreement and the Agreement has been filed with, and approved by, the Commission.

J. National Market System (''NMS'') Plans and the Options Clearing Corporation

The Commission's approval of the BSE's proposed rule change will not be effective until the BSE has become a participant in several NMS plans. Specifically, the BSE must join the Plan for the Reporting of Consolidated Options Last Sale Reports and Quotation Information (known as the Options Price Reporting Authority (''OPRA'')), the Linkage Plan, and the Options Listing Procedures Plan (''OLPP''). In addition, the BSE will need to become a participant in the Options Clearing Corporation.

IV. Consideration of Burden on Competition and Promotion of Efficiency, Competition, and Capital Formation

In reviewing the BSE's proposal, the Commission is required under section 3(f) of the Act,[304] to consider whether the proposal will promote competition, efficiency, and capital formation. In addition, section 6(b)(8) requires that the rules of an exchange not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.[305]

As noted above, the proposed BOX facility would provide a new fully automatic electronic trading market for options. In the Commission's view, if the BOX market is successful in attracting new market participants and order flow, the facility could serve as a new source of liquidity for options investors and promote greater competition among options market centers. In particular, the BOX system, in contrast to the other options exchanges, would have multiple and competing market makers rather than a specialist-driven system. There would be no designated specialists, primary market makers, or lead market makers with authority to control trading in a particular options class. Market making in an options class on BOX would be open to all qualified Options Participants who are approved by the Exchange as Market Makers.

Additionally, BOX's trading rules are designed to establish an anonymous central order book with price/time priority, which may result in better pricing because trading participants have an incentive to post their very best prices rapidly. Moreover, the BOX PIP presents the opportunity for increased competition for Customer Orders and will guarantee the Customer Order that initiates the PIP receives price improvement of at least $.01 over the current NBBO.

If BOX succeeds in attracting order flow, it may serve as a great source of liquidity for investors, and this, in turn, could promote greater efficiency of executions. Similarly, the availability of novel features should provide investors and issuers with new opportunities to interact, thereby encouraging capital formation.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 4, including whether the proposed amendment is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Comments may also be submitted electronically at the following e-mail address: *rule-comments@sec.gov.* All comment letters should refer to File No. SR–BSE–2002–15. This file number should be included on the subject line if e-mail is used. To help us process and review comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying at the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should be submitted by February 10, 2004.

VI. Accelerated Approval of Amendment No. 4

Pursuant to section 19(b)(2) of the Act,[306] the Commission may not approve any proposed rule change, or amendment thereto, prior to the 30th day after the date of publication of notice of the filing thereof, unless the Commission finds good cause for so doing and publishes its reasons for so finding. The Commission hereby finds good cause for approving Amendment No. 4 to the proposal, prior to the 30th day after publishing notice of Amendment No. 4 in the **Federal Register**. Many of the revisions made to the proposal in the BSE's Amendment No. 4 are modeled on existing rules of the other options exchanges. The Commission previously approved these rules and, therefore, believes that accelerating such rules for the BOX market is appropriate because these revisions do not raise new regulatory issues. Other revisions, although not based on existing SRO rules, were not

[301] 17 CFR 240.17d–2.

[302] *See* Securities Exchange Act Release No. 46590 (October 2, 2002), 67 FR 63474 (October 11, 2003).

[303] *See* proposed BOX Rules, Chapter XI, sec. 1.

[304] 15 U.S.C. 78c(f).

[305] 15 U.S.C. 78f(b)(8).

[306] 15 U.S.C. 78s(b)(2).

material to the overall proposal. The Commission believes that little purpose would be served by delaying approval of the proposal until those additional revisions had been published for comment. The Commission believes that it has received and fully considered substantial, meaningful comments with respect to the BSE's proposal, as amended, and that Amendment No. 4 does not raise issues that warrant further delay. Accordingly, pursuant to section 19(b)(2) of the Act,[307] the Commission finds good cause to approve Amendment No. 4 prior to the 30th day after notice of the Amendment is published in the **Federal Register**.

VII. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, with section 6(b)(5) of the Act.[308]

It is therefore ordered, pursuant to section 19(b)(2) of the Act,[309] that the proposed rule change (SR–BSE–2002–15), as amended, is hereby finally approved, and Amendment No. 4 to the proposed rule change is hereby granted accelerated approval.

Although, the Commission's approval of the BSE's proposed rule change to establish trading rules for the BOX facility is final, it will not be effective until the BSE takes the following actions:

(1) *Participation in the Options Self-Regulatory Council (''OSRC'').* The BSE must become a signatory to the 17d–2 agreement administered by the OSRC, which is a plan for the allocation of regulatory responsibility approved by the Commission under Rule 17d–2 of the Exchange Act.

(2) *Participation in the National Market System Plans relating to options trading.* The BSE must join the Options Price Reporting Authority, the Options Listing Procedures Plan, and the Options Linkage Authority.

(3) *Examination by the Commission.* The BSE must demonstrate to the satisfaction of Commission staff in the Office of Compliance Inspections and Examinations (''OCIE'') that it has adequate surveillance programs and procedures in place to monitor trading on BOX and that BOX Options Participants can comply with the trade-through requirements of the Linkage Plan with regard to all trades effected through BOX or any exemption from such Linkage Plan requirements. OCIE shall evidence its satisfaction by issuing a letter to the BSE.

(4) The BSE must file a separate proposed rule change with the Commission pursuant to section 19(b) of the Act,[310] to amend the BOX Rules as follows:[311]

- *Market Opening.* As noted above, the BSE must amend Chapter V, section 9 of the proposed BOX Rules relating to the market opening to provide a more detailed description of the market opening procedures. Among other things, the BSE must clarify the proposed procedures for determining an opening price, including the pre-opening and the Theoretical Opening Price. In addition, the BSE must add a provision relating to the interaction of Customer Orders during the market opening.
- *Anticipatory Hedging.* As noted above, the BSE must amend the proposed BOX Rules to prohibit any person associated with an Options Participant who has knowledge of all material terms and conditions of (i) an order and a solicited order, (ii) an order being facilitated, or (iii) orders being crossed, the execution of which are imminent, to enter, based on such knowledge, an order to buy/sell the option, the underlying security, or any related instrument until the terms are disclosed to the trading crowd or the trade can no longer be considered imminent.
- *Exercise of Options Contracts.* The BSE must amend Chapter VII, section 1 of the proposed BOX Rules to clarify the provisions relating to contrary exercise advice.
- *Complex Orders.* As noted above, the BSE must amend the proposed BOX rules to specify the process for BOX Participants to notify BOX of a proposed strategy and the procedure for sending advisory messages.

Each of these conditions to file proposed rule changes will be satisfied upon effectiveness under section 19(b) of the Act.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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[307] 15 U.S.C. 78s(b)(2).

[308] 15 U.S.C. 78f(b)(5). In connection with the issuance of this approval order, neither the Commission nor the staff is granting any exemptive or no-action relief from the requirements of Rule 10b–10 under the Act. 17 CFR 240.10b–10. Accordingly, a broker-dealer executing a customer order through BOX will need to comply with all applicable requirements of this Rule.

[309] 15 U.S.C. 78s(b)(2).

[310] 15 U.S.C. 78s(b).

[311] The Commission is requiring these amendments so that the BOX Rules are comparable with the rules of the other options exchanges.

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–49056; File No. SR–ISE–2003–07]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by International Securities Exchange, Inc., Relating to Pricing of Block and Facilitation Trades

January 12, 2004.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on February 25, 2003, the International Securities Exchange, Inc. (''Exchange'' or ''ISE'') filed with the Securities and Exchange Commission (''Commission'') the proposed rule change as described in items I, II, and III below, which items have been prepared by the self-regulatory organization. On December 18, 2003, the Exchange amended the proposed rule change. The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The ISE is proposing to provide for the entry and execution of block and facilitation trades at the midpoint between the standard trading increments. The text of the proposed rule change is set forth below. Proposed new language is in *italics*; proposed deletions are in [brackets].

* * * * *

Rule 716. Block Trades

* * * * *

(a) Block-Size Orders. Block-size orders are orders for fifty (50) contracts or more.

(b) For purposes of this Rule, *a ''broadcast message'' means an electronic message that is sent by the Exchange to all Members, and a ''Response'' means an electronic message that is sent by Members in response to a broadcast message* [the term ''Crowd Participants'' means the market makers appointed to an options class under Rule 803, as well as other

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.