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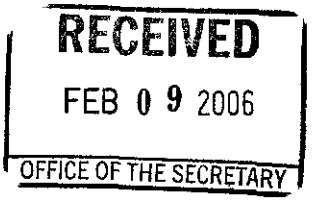
AMERICAN
STOCK EXCHANGE®
Equities Options ETFs

Neal L. Wolkoff
Chairman & Chief Executive Officer

American Stock Exchange
86 Trinity Place
New York, NY 10006-1872
T 212 306 2200
F 212 306 5464
neal.wolkoff@amex.com

February 7, 2006



Ms. Nancy M. Morris
Secretary
Securities and Exchange
Commission
100 F Street, N.E.
Washington D.C. 20549

Re: Missing Exhibits A and B to the Exchange's February 3, 2006 Letter Commenting on the Boston Stock Exchange ("BSE") Directed Order Process on the Boston Options Exchange ("BOX")(SR-BSE-2005-52) and International Securities Exchange, Inc. ("ISE") Directed Order System Change ("SR-ISE-2006-02)

Dear Ms. Morris:

Enclosed are Exhibits A and B referenced in our comment letter to the Commission dated February 3, 2006. The Exhibits were intended to be part of our submission recently delivered to the Commission.

If you have any questions or comments, please contact me.

Sincerely,

cc: Robert L. Colby
Elizabeth K. King
Deborah Lassman Flynn

Enclosures

Exhibit A

Michael J. Ryan, Jr.
Executive Vice President &General Counsel

American Stock Exchange
86 Trinity Place
New York, New York
T 212.306.1200
F 212.306.1152
michael.ryan@amex.com

AMERICAN STOCK EXCHANGE
Equities Options ETFs

February 14, 2003

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

Re: Boston Options Exchange ("BOX") Facility (File No. SR-BSE-2002-15)

Dear Mr. Katz:

The American Stock Exchange LLC submits the following comments with respect to the above captioned matter.

1. The *Federal Register* Notice is Deficient and Does not Provide Sufficient Information for Meaningful Public Comment

The *Federal Register* Notice for BOX[1] and its proposed rules provides no information with respect to the exchange's ownership, governance structure, regulatory program, how BOX would coordinate its regulatory program with the programs of other self-regulators, and the manner in which BOX would integrate into national market systems plans such as OPRA and the options linkage. The *Federal Register* notice states that BOX would be operated by the Boston Options Exchange Group, LLC (BOX LLC). The notice further states that, "the founding members of BOX LLC are the BSE, the Bourse de Montreal, Inc., and Interactive Brokers Group, LLC."[2] The Notice does not identify the current owners of BOX LLC, their ownership interests, or describe the role of Interactive Brokers or the Bourse de Montreal in the market. There is no description of any agreements between or among the members of BOX LLC or other parties providing critical services to the exchange. It is impossible to determine from the Notice whether the proposed new market has established satisfactory procedures to prevent Interactive Brokers and its market maker affiliate (Timber Hill) from having inappropriate advantage over other market participants by virtue of Interactive Brokers' role in the market. In the absence of more information, it is also impossible to determine whether BOX truly is a facility of BSE (and, thus, need not seek separate registration as a national securities exchange) or whether the BSE does not control BOX (in which case BOX would need to separately register as a national securities exchange).

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1 68 FR 3062 (January 22, 2003).
2 68 FR 3063, footnote 7.

For the reasons described above, the *Federal Register* Notice for BOX is deficient and fails to provide adequate notice and opportunity for meaningful public comment on the proposed new options exchange. We ask the Commission to again publish the BOX proposal with the sufficient information to allow for informed public comment.

2. The Membership Rules of BOX are Anti-Competitive and Inconsistent with Section 6(b)(2) of the Securities Exchange Act

The *Federal Register* Notice for BOX repeatedly trumpets the "flat and open" structure of the market. Chapter II, Section 2(b) of its proposed rules, however, limits membership in BOX to customer carrying firms through the requirement that all BOX members must be assigned to a Designated Options Examining Authority ("DOEA") under the options sales practice 17d-2 Agreement.[3] Since the options sales practice 17d-2 Agreement only allocates regulatory responsibility for the review of option sales practices by customer carrying, dual member firms, this requirement would limit membership on BOX to such firms.[4]

Limiting membership on BOX to customer carrying firms makes perfect business sense for BOX if it intends to be a market for internalizers because it would prohibit many market making firms from becoming members and thereby lessen competition for internalized orders. The proposed limitation on membership, however, is contrary to Section 6(b)(2) of the Securities Exchange Act which states, "Subject to the provisions of subsection (c) of this section, the rules of the exchange [seeking registration shall] provide that any registered broker or dealer or natural person associated with a registered broker or dealer may become a member of such exchange and any person may become associated with a member thereof."[5] (Emphasis supplied.)

Limiting membership to customer carrying firms is inconsistent with the "fair access" requirement of Section 6(b)(2). Such a limitation, for example, would exclude market-making firms from membership in BOX if such firms do not also carry customer accounts. This would be anti-competitive and contrary to the interests of investors because it would limit competition on the intra-market level for investor orders sent to

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[3] Chapter II, Section 2(b) of the proposed BOX rules states, "Options Participants must be registered as broker-dealers pursuant to Section 15 of the Exchange Act, and must be assigned to a Designated Options Examining Authority ("DOEA") pursuant to Rule 17d-2 of the Exchange Act."

[4] Footnote 16 in the Federal Register notice states: "The OSRC [Options Self-Regulatory Council] is currently operating under a draft agreement, as opposed to a formal plan declared effective by the Commission pursuant to Section 11A of the Act." There are two fundamental errors in this statement. First, the Commission approved the Plan that established the Options Self-Regulatory Council on September 8, 1983 (Securities Exchange Act Release No. 20158, 48 FR 41256 (September 14, 1983), and approved revisions to the Plan on November 8, 2002 (Securities Exchange Act Release No. 46800, 67 FR 69774 (November 19, 2002). The Plan, accordingly, is not a draft. Second, the Plan is not a national market system plan under Section 11A of the Act; it is a plan to allocate regulatory responsibilities under Commission Rule 17d-2.

[5] For a number of reasons that we would be pleased to discuss with the Commission staff, we believe that the qualifications in subsection (c) of Section 6 would not permit BOX to limit membership in the exchange to customer carrying, dual member firms.

BOX by prohibiting market making firms (registered dealers) from competing for the order flow. In short, the proposed membership requirement for BOX is contrary to the interests of investors, anti-competitive, and inconsistent with the requirements of the Act.

We would have similar concerns if BOX proposed a rule that required a prospective member to be "designated" by the Commission for examination purposes to another SRO pursuant to Regulation 17d-1. Such a requirement would violate the fair access requirement of Section 6(b)(2) by conditioning membership in BOX on membership in another SRO that would perform the responsibilities of the Designated Examining Authority. Such a requirement also would be anti-competitive on both the intra-market level (by prohibiting sole members of BOX) and on the inter-market level (by pushing the costs of self-regulation onto other SROs).

3. BOX May Facilitate a "Raid" on the U.S. Treasury

Persons registered with a national securities exchange as specialists and market makers in equity options ("options dealers" in the language of the Internal Revenue Code) currently are eligible under Section 1256 of the Code for 60/40-tax treatment. This means gains or losses on their options positions are treated as 60% long term and 40% short-term capital gains/losses. In contrast, most other persons who buy and sell options are taxed at 100% short-term capital gains/losses unless the person held a long option position for more than a year, in which case the long-term capital gains rate applies. There is a significant tax advantage, accordingly, to be registered as a option specialist or market maker on a national securities exchange. These persons also are eligible for "good faith" margin, have an exemption from the prohibition on member trading in Section 11(a)(1) of the Securities Exchange Act, and consequently have additional competitive advantages relative to other persons trading options.

All options exchanges currently are limited access markets, so there is a cap on the number of persons eligible for 60/40-tax treatment and good faith margin. If BOX truly has "an open and flat" market, with no meaningful limitation on the number of persons that may claim market maker status in a particular option, and also features low entry costs, then there may be no meaningful limitation on the number or persons eligible for 60/40 tax treatment.[6] In addition, the market maker obligations on BOX are less burdensome than those on other exchanges (e.g., the proposed BOX rules impose no negative obligations on BOX market makers). Thus, persons registered as market makers on BOX may be able to always auto-quote outside the NBBO, trade opportunistically, and still gain the benefits of 60/40-tax treatment and market maker margin. The revenues of the government will be adversely affected if a potentially unlimited number of opportunistic electronic traders masquerading as market makers are allowed to convert ordinary income into long-term capital gains.

The solution is to require BOX to adopt rules that: (1) prohibit persons registered as market makers from always auto-quoting outside the NBBO, and (2) require BOX

[6] Chapter VI, Section 1(c) of the proposed BOX rules provides in relevant part: "These Rules place no limit on the number of qualifying entities that may become Market Makers."

market makers to effect more than two thirds of their transactions with persons who are neither registered as market makers on BOX nor customers of that market maker. Internalized trades and trades that take liquidity from the market (i.e., trades with other market makers) should not be considered in determining whether a person is a bona-fide market maker. Generating quotes electronically that no one cares about also is inconsistent with acting as a bona-fide market maker.

Always auto-quoting outside the NBBO does not satisfy the statutory definition of a market maker as, "a person that holds himself out as being willing to buy and sell security for his own account on a regular and continuous basis," since always auto-quoting outside the NBBO evidences a desire NOT to trade at the displayed prices. Our proposal also is consistent with the margin requirements of Section 7(c)(3)(A) of the Securities Exchange Act which exempts from margin requirements a member of a national securities exchange or a registered broker or dealer, "a substantial portion of whose business consists of transactions with persons other than brokers or dealers." Our proposal reasonably extends the logic of Section 7(c)(3)(A) of the Exchange Act to determine market maker status by basing this status on effecting a substantial portion of trades with persons other than registered market makers on their market. Finally, in view of Chairman Pitt's recent call to eliminate internalization on options exchanges,[7] we do not believe that internalized trades should be used in determining whether a person qualifies as a market maker.

4. The Commission Should Review the Impact of Section 11(a) and Regulations Thereunder on BOX

Section 11(a) prohibits a member of a national securities exchange from effecting on the exchange where it is a member trades for (i) its proprietary account, (ii) the account of its associated persons, and (iii) accounts over which it or its associated persons exercise investment discretion. The prohibition against member trading applies to orders initiated both on and off the floor unless a specific exemption exists in Section 11(a) or the rules adopted thereunder. The SEC has applied Section 11(a) to all registered national securities exchanges (including the Cincinnati Stock Exchange which, like BOX, is a decentralized electronic exchange) and it remains an important part of the pattern of regulation applicable to stock exchanges and their members.

We believe that the Commission should undertake a thorough analysis of the application of Section 11(a) and associated regulations to the proposed BOX. A non-comprehensive list of 11(a) issues that the Commission should examine follows:

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[7] *See*, letter from Harvey L. Pitt, Chairman, SEC, to Salvatore F. Sodano, Chairman and Chief Executive Officer, Amex, dated January 24, 2003 ("Pitt Letter"). In this letter, Chairman Pitt writes:

> As a self-regulatory organization, The American Stock Exchange is obligated to enforce compliance by its members with the securities laws, including its members' best execution obligations. At the same time, the Amex guarantees its members the right to internalize some proportion of their customers' order flow...These exchange rules also have the potential to encourage firms to consider their own economic interests over those of their customers. For these reasons, I believe you and the other options exchanges should eliminate them.

- The concept of orders initiated "on-floor" vs. "off-floor" is important in Section 11(a) analyses and, in an electronic exchange, the boundaries of the floor are not immediately obvious. The CSE, by rule, defines its floor to include any location where one of its terminals is located.[8] Since (1) the proposed rules of BOX provide that their market makers, "are designated as specialists on BOX for all purposes under the Exchange Act or Rules thereunder," (2) specialists and market makers operate on exchange floors, and (3) BOX market makers operate from terminals in different geographical locations, we believe that the Commission should follow the CSE precedent and define the BOX floor to be any location where there is a BOX terminal.

- The proposed PIP would allow order flow providers that are not registered market makers to send paired customer and offsetting proprietary orders to be crossed in BOX. The proprietary order needs an exemption from Section 11(a), and we do not believe that the "effect vs. execute" rule (Regulation 11a2-2(T)) would be available for paired orders that are crossed on BOX. There are four conditions on the availability of the effect vs. execute rule, three of which are relevant to the present analysis. These are: (1) the transaction must be executed on the floor, or through use of the facilities of the exchange, by a member (the "executing member") which is not an associated person of the initiating member, (2) the order must be transmitted from off the floor of the exchange (i.e., the exemption is unavailable for orders initiated on-floor), and (3) neither the initiating member nor any associated person of the initiating member may participate in the execution of the transaction at any time after the order for the transaction has been transmitted. We do not believe that the "off floor" component of the effect vs. execute rule is satisfied for the reasons described above. For the following reasons, moreover, we also do not believe that "unaffiliated member" or "non-participation" tests for the "effect vs. execute" rule are met for the entry on BOX of a paired customer and proprietary orders. First, the order flow provider is entering a paired order to be crossed at a price determined by the order flow provider in the "primary improvement order." The order flow provider is not merely seeking to trade at the market available on the exchange when its order arrives on the floor; instead, the order flow provider is making its own bid and offer inside the exchange market. The OFP, thus, "controls" the market on BOX in a manner that is inconsistent with both the "unaffiliated member" and "non-participation" requirements. Second, the order flow provider may modify its improvement order to meet or beat competition from market makers after entry of its primary improvement order or chose to do nothing in response to other improvement orders in the PIP. In all cases, the order flow provider (even if deemed to be off-floor, which we do not believe is appropriate) retains control over the execution of its order and fully participates in the PIP auction. A second person (the unaffiliated "executing member") is never involved in the execution. The PIP process also should be contrasted with auto-ex transactions on other exchanges where the initiating off-floor member order is automatically executed against the prevailing bid-offer available on the exchange when the order arrives,

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[8] CSE Rule 11.9(a)(9).

and the off-floor member does not control the market on the floor or participate in an auction. The Commission, accordingly, should review the availability of the "effect vs. execute" exemption to order flow providers that are not registered as market makers that seek to cross (internalize) orders on BOX.

- The price/time priority procedures of BOX appear inconsistent with the availability of the exemption under Section 11(a)(1)(G) and Regulation 11a1-1(T) ("Transactions Yielding Priority, Parity and Precedence). Similarly, the priority rules of the PIP which guarantee a percentage of the trade to the order flow provider also appear inconsistent with the availability of the "yielding" exemption under Section 11(a)(1)(G) and Regulation 11a1-1(T).[9] In reviewing the applicability of Section 11(a)(1)(G) to the CSE, the Commission stated that the "G" order exemption was available to CSE members because CSE's rules reflect the yielding procedures required by Section 11(a)(1)(G)(ii).[10] A market that operates on a time priority basis or that gives internalizers priority in cross trades, by definition, does not provide an opportunity for members to "yield" to non-members and, thus, members on such an exchange would be unable to use the "G" order exemption. The Commission, accordingly, should review the availability of the "G" exemption to BOX members.

5. Internalization

It is clear to us that a primary business of BOX is to function as a market for persons seeking to internalize their options order flow. We, therefore, find considerable irony in the publication of the BOX rule package at the time that Chairman Pitt is calling on options exchanges to end rules that facilitate internalization.[11]

As we have stated on numerous occasions, [12] the Amex opposes internalization and we continue to believe that it undermines both national market system goals and a broker's best execution obligations. Internalization allows broker-dealers to "look" at their customer orders prior to determining whether to execute (internalize) them or send them to unaffiliated market makers for execution. This "cherry-picking" of orders conceptually is antagonistic to a broker's duty of best execution. If conducted on a large

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[9] *See,* Chapter V, Section 18(f)(i) of the proposed BOX rules which provides that the order flow provider retains priority over other orders in the PIP.

[10] Securities Exchange Act Release No. 15533 (January 29, 1979), note 32 and accompanying text.

[11] *See*, Pitt Letter at note 7 above.

[12] *See*, e.g., letter from James R. Jones, Chairman, Amex, to Jonathan Katz, Secretary, SEC, dated December 8, 1992; Testimony of James R. Jones, Chairman, Amex, before the House Subcommittee on Telecommunications and Finance, dated, April 14, 1993; letter from Jules L. Winters, Chief Operating Officer, Amex, to The Honorable Edward J. Markey, Chairman, and The Honorable Jack Fields, Ranking Republican Member, House Subcommittee on Telecommunications and Finance, dated April 7, 1994; letters from James F. Duffy, Executive Vice President and General Counsel, Amex, to Jonathan Katz, Secretary, SEC, dated September 22, 1995 and April 20, 1995; letter from Thomas F. Ryan, Jr., President and COO, Amex, to Jonathan Katz, Secretary, SEC, dated February 1, 1996, letter from Michael J. Ryan, Jr., Executive Vice President and General Counsel, Amex, to Jonathan G. Katz, Secretary, SEC, dated August 29, 2001, and letter from Michael J. Ryan, Jr., Executive Vice President and General Counsel, Amex, to Jonathan G. Katz, Secretary, SEC, dated April 22, 2002.

scale, moreover, it also leads to the deterioration of quoted markets on exchanges as exchange market makers widen their quotes in the expectation that only difficult orders will be routed to them. These wider quotes provide additional opportunities for internalization. The ability to "penny" the NBBO also will disadvantage limit orders on BOX and other option markets as BOX market makers and order flow providers will be able to step in front of these limit orders for a nominal amount whenever they perceive that it is in their economic interests to do so. Limit orders at the inside on BOX only will be executed when the BOX crowd perceives no advantage to stepping in front of them. The PIP rules, moreover, only permit the market makers in the option and OFP to participate in the PIP; limit orders at the inside and all other market participants do not see the PIP and are excluded from it. Thus, the rules of BOX do not reward investors that provide liquidity to the market by entering limit orders at the inside market.

We recognize that the proposed BOX rules permit internalization with a nominal, penny improvement over the NBBO. BOX rules, however, do not encourage competition among its market makers and order flow providers.[13] The OFP is permitted to improve its primary improvement order to match competition from market makers in the option without regard to time priority. Thus, the principal of time priority is disregarded with respect to the OFP when time priority most matters on BOX, i.e., when an order flow provider seeks to cross an order. This will encourage order flow providers to submit primary improvement orders at no more than a penny better than the current national market and then wait to see if further improvement is necessary. The ability of the order flow provider to match (i.e., "me too...") prices submitted by market makers in the option also will discourage market makers from competing for order flow.

In example number 8 in the *Federal Register* Notice, the hypothetical states that there is a 100 contract sell order that the OFP seeks to cross at 2.01. In time priority, MMB bids 2.05 for 10, MMC bids 2.04 for 30, and MMA (the market maker prime) bids 2.04 for 50. The buy-side of this trade is allocated in the following manner: MMB is filled in full on 10 contracts at 2.05, the OFP receives 36 contracts (a full 40% share of the remaining 90 contracts) at 2.04, MMC is filled on 30 at 2.04, and MMA buys 24 of 50 contracts bid for at 2.04. Even when the order flow provider is NOT at the best price, it still gets 40% of whatever is unfilled at the superior price. This is not related to rewarding it for improving the price but rather rewarding the OFP for bringing the order to BOX. The three-second "flash" of the PIP is so short, moreover, that it prevents consideration by humans of the customer order. This will necessarily limit competition by favoring highly automated trading firms such as Interactive Brokers' market making affiliate, Timber Hill. As the notice states:

> As a practical matter, the PIP process for all Options Participants would necessarily be governed by computerized systems, not by human traders. Market Makers and OFPs can easily either develop their own software to manage trading

[13] We assume, for the sake of this discussion, that the rules of BOX do not limit membership to customer carrying, dual member firms. (See the discussion above.) If BOX's rules do limit membership to customer carrying firms, the possibility of price competition in the PIP would be even more substantially restricted.

on BOX, or utilize one of the many front-end solutions that have been written to connect electronic-based exchanges.[14]

We agree that computerized systems are necessary to participate in the PIP, but we disagree that the specialized software to participate in the PIP is either widely available or easily developed. Since access to the PIP is central to the operation of BOX, BOX should substantiate its claim of easy availability of the specialized software to participate in the PIP. If this software is not easily available, moreover, the Commission should consider requiring the exchange to provide the software, together with updates, to its members to ensure that they have fair access to the market.

6. Impact on National Market System

The proposed BOX rules would incent persons to have "hair triggers" with respect to changing their quotes since persons are rewarded for being first at a particular price. Thus, if there are a number of BOX market makers in a particular option that quote competitively (as opposed to always auto-quoting outside the NBBO), each will have a strong incentive to race to revise its quote if there is any change in the price of the underlying. This flood of quotes to respond to changes in the underlying securities does not benefit the national market system since it burdens the mechanisms of the system without sufficiently offsetting benefits. It is not as necessary to reward time priority in options as it is in stocks because option quotes vary in response to changes in the price of the underlying security whereas changes in stock quotes signal alterations in supply and demand. Some option pricing models, moreover, update quotes based upon factors other than the underlying stock (such as changes in index futures or the firm's proprietary position in one or more financial instruments), which will further add to the burden on the national market system. The ISE currently generates more quote traffic in the approximately 530 options that it lists than the Amex and CBOE generate in the more than 3,000 equity options that they list. BOX would place even more burden on OPRA, market data vendors, markets and other users of real time quote information as a result of a rush by BOX market makers to revise their quotes in response to any changes in the underlying securities or other factors.

The Commission should not allow BOX to shift the costs of its market model (i.e., processing large volumes of largely useless quotes for a market that essentially will exist to facilitate internalization) onto other participants of the national market system (i.e., exchanges, OPRA, quote vendors and users of real-time market data). This cost shifting effectively is a tax on other national market system participants and consequently has an adverse impact on competition that is not necessary or appropriate in the interest of investors or the national market. The volume of information produced by BOX will adversely affect the performance of other exchanges' systems with a resulting adverse impact on investors that trade in these markets. Exchanges other than BOX also will have to spend resources to accommodate information received from BOX that otherwise could be spent on systems that could execute their customers' orders better, cheaper and

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[14] 68 FR 3068.

faster. The Commission, therefore, should take action to minimize the volume of quote changes generated by BOX.

7. Conclusions

We request the Commission to undertake the following actions with respect to the BOX proposal:

- The Commission should republish the BOX proposal with sufficient information to permit informed public comment. Specifically, the new *Federal Register* Notice should include information with respect to the ownership of BOX LLC, its governance structure, the BOX regulatory program, the manner in which BOX would integrate into national market systems plans such as OPRA and the options linkage, the manner in which BOX will integrate its regulatory program into the pattern of self-regulation, the role of Interactive Brokers and the Bourse de Montreal in BOX, and the steps taken to ensure that Interactive Brokers and Timber Hill do not have any advantage over other market participants in BOX by virtue of Interactive Brokers' role in the market.

- The Commission should not approve the proposed membership rule of BOX that limits membership in BOX to broker-dealers that are assigned to a Designated Options Examining Authority pursuant to the options 17d-2 Agreement. (Chapter II, Section 2(b) of the Box Rules ("Qualification Requirements for Options Participants")). This has the practical effect of limiting membership in BOX to customer carrying firms and would exclude from membership firms that engage in market making without carrying customer accounts. The proposed rule is plainly inconsistent with the fair access requirements of Section 6(b)(2) of the Exchange Act which requires membership in national securities exchanges to be available to (1) all registered brokers (i.e., firms acting as agent) AND (2) all dealers (firms acting as principal, e.g., market makers). The proposed rule is anti-competitive because it reduces competition for orders sent to BOX by eliminating many market making firms from membership and thus, facilitates internalization without competition. We would have similar concerns if BOX proposed a rule that required a prospective member to be "designated" by the Commission for examination purposes to another SRO pursuant to Regulation 17d-1. Such a requirement would violate the fair access requirement of Section 6(b)(2) by conditioning membership in BOX on membership in another SRO that would perform the responsibilities of the Designated Examining Authority. Such a requirement also would be anti-competitive on both the intra-market level (by prohibiting sole members of BOX) and on the inter-market level (by pushing the costs of self-regulation onto other SROs).

- The Commission should require BOX to adopt rules that: (1) prohibit persons registered as market makers from always auto-quoting outside the NBBO, and (2) require BOX market makers to effect more than two thirds of their transactions with persons who are neither registered as market makers on BOX nor customers

of that market maker. These proposals are necessary to prevent persons that are not bona-fide market makers from obtaining market maker margin, an exemption from Section 11(a), and 60/40-tax treatment under Section 1256 of the Internal Revenue Code.

- The Commission should undertake and publish an analysis of the application of Section 11(a) to the proposed BOX. Section 11(a) and its associated regulations are complex, and we believe that members of BOX need clear guidance from the Commission as to how these rules will apply to them. Moreover, our preliminary review of certain aspects of the BOX rule package indicates (1) there may be Section 11(a) liability for order flow providers that are not market makers participating in the PIP, (2) the "G" order exemption would not be available on BOX since there is no provision for members' orders yielding, and (3) the boundaries of the BOX "floor" for Section 11 analysis should be defined, consistent with the CSE precedent, to include any location where there is a BOX terminal.

- The BOX rules for internalization are inconsistent with Chairman Pitt's recent call to the options exchanges to prohibit SRO rules that facilitate internalization. The Commission, accordingly, should not approve the BOX internalization rules until the Commission has undertaken a thorough review of internalization practices. At a minimum, the three second order exposure requirement is far shorter than any similar order exposure period previously approved by the Commission and should be lengthened to at least equal the minimal order exposure period now in effect at ISE (10 seconds).[15] The Commission also should consider whether it should require BOX to provide its members with software, and updates, to allow them to participate in the PIP as a "fair access" requirement.

- The Commission should explore methods of quote mitigation in the context of an automated market that features time priority at a given price. The volume of information produced by BOX will adversely affect the performance of other exchanges' systems with a consequent adverse impact on investors that trade in their markets. The quote stream from BOX also will burden OPRA, quote vendors and users of real-time option quote information without any offsetting benefit since the maker will exist primarily to facilitate internalization. Exchanges other than BOX also will have to spend resources to accommodate information received from BOX that otherwise could be spent on systems that could execute customer orders better, cheaper and faster. This will adversely impact competition among market and market makers. Approval of BOX as

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[15] For reasons stated in our earlier correspondence on SR-ISE-2001-19, we believe that the even the 10-second "flash" in the ISE's rules is too short to provide adequate exposure of customer orders to other market participants. *See*, letter from Michael J. Ryan, Jr., Executive Vice President and General Counsel, Amex, to Jonathan G. Katz, Secretary, SEC, dated August 29, 2001, and letter from Michael J. Ryan, Jr., Executive Vice President and General Counsel, Amex, to Jonathan G. Katz, Secretary, SEC, dated April 22, 2002.

currently proposed, accordingly, would be contrary to the interests of investors and the national market system.

* * * * *

We appreciate the opportunity to comment on the BOX filing and would be pleased to provide further information regarding our views if requested.

Very truly yours,

cc: Chairman William Donaldson
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Commissioner Paul S. Atkins
Commissioner Roel C. Campos

Annette L. Nazareth
Director, Division of Market Regulation

Robert L.D. Colby
Deputy Director, Division of Market Regulation

Elizabeth King
Associate Director, Division of Market Regulation

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Exhibit B

Michael J. Ryan, Jr.
Executive Vice President and General Counsel

American Stock Exchange
86 Trinity Place
New York, New York 10006-1872
T 212 306 1000
F 212 306 1152
michael.ryan@amex.com

September 12, 2003

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

Re: Amendment No. 3 to the Boston Options Exchange ("BOX") Facility (File No. SR-BSE-2002-15)

Dear Mr. Katz:

The American Stock Exchange, LLC ("Amex" or "Exchange") appreciates this opportunity to comment on Amendment No. 3 to SR-BSE-2002-15 that would establish trading rules for the Boston Options Exchange Facility (the "BOX").[1] By letters dated February 14, 2003, and March 13, 2003, the Exchange previously commented on the proposed rules as originally noticed in the *Federal Register* in January 2003.[2] For the reasons stated in our prior letter, we believe that the Commission should require additional amendments to the trading rules and structure of the BOX prior to approval. The Amex submits this letter for the purpose of commenting upon the changes made by BOX in connection with its proposed trading rules.

Ownership of BOX

BOX indicates that there are three (3) founding members of BOX: the Boston Stock Exchange, Inc. ("BSE"), the Bourse de Montreal, Inc. and Interactive Brokers LLC. In addition, BOX has attracted four (4) investors: CSFB Next Fund, Inc., LabMorgan Corporation, Solomon Brothers Holding Company, Inc. and UBS (USA) Inc. The Amendment No. 3 Notice as well as prior notices published in the *Federal Register* fails to detail the ownership structure of BOX, *i.e.* the parties having a financial interest in the venture. We reiterate our concerns set forth in letters to the Commission dated February 14, 2003 and March 13, 2003. Because broker-dealers that have a significant options business may also have a significant financial stake in BOX, the Amex believes that BOX should be required to fully disclose 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

[1] *See* Securities Exchange Act Release No. 48355 (August 15, 2003), 68 FR 50813 (August 22, 2003)("Amendment No. 3 Notice").

[2] *See* Securities Exchange Act Release No. 47186 (January 14, 2003), 68 FR 3062 (January 22, 2003)(the "Original Notice").

BOX. We are acutely concerned that option order flow providers may disadvantage other options exchanges because of routing decisions based on having a financial stake in a new exchange rather than the interests of the public customer. We believe that a significant interest in such an entity is anti-competitive and provides inherent conflicts that may not be easily resolved through *prophylactic measures*. Accordingly, the Commission should require BOX to better explain and disclose the relationship of its owners and investors.

Internalization

The Commission in its December 2000 *Special Study on Payment for Order Flow and Internalization in the Options Markets*[3] expressed concern over certain anti-competitive order routing practices such as internalization[4] and payment for order flow. Internalization in the options markets occurs where a broker-dealer facilitating a customer order exclusively interacts as the counterparty without the ability of other market participants to trade against those same customer orders. Because the floor-based options exchanges generally require a customer order to be exposed to the trading crowd prior to such facilitation, the concern over internalization or perfunctory matching is substantially reduced. However, the BOX proposal, by reducing to just three (3) seconds the PIP process, may substantially increase the amount of internalization of customer orders conducted by OFPs and affiliated firms.

Then-Chairman Arthur Levitt in a speech entitled *Visible Prices, Accessible Markets, Order Interaction*[5] noted that broker-dealers who buy and sell from their customers and wholesale firms that pay for order flow may not have incentive to compete for order flow with other market participants. In this manner, these practices discourage rigorous price competition by the internalizing or paying firm. The fact the BOX intends to require that order flow providers ("OFPs")[6] and Market Makers[7] better the NBBO by at least $0.01 does not change this fact. OFPs (and affiliated Market Makers) will effectively be assured of the order flow. Thus, the Customer Order will be crossed by the OFP without "true" exposure to the trading market. We believe the SEC Chairman's concerns are relevant to the BOX proposal because the establishment of a three (3) second PIP would permit a greater opportunity for internalizing options order flow.

The ability to "penny" the NBBO also will disadvantage limit orders on BOX and other options markets as BOX Market Makers and OFPs will be able to step in front of these limit orders for a nominal amount whenever they perceive that it is in their economic interests to do so. Limit orders at the inside on BOX only will be executed when the BOX crowd perceives no advantage to stepping in front of them. We recognize that the proposed BOX rules permit internalization with a nominal, penny improvement over the NBBO. We do not believe, however, that BOX rules encourage competition among its Market Makers and OFPs. The OFP is permitted to improve its Primary Improvement Order to match competition from Market Makers in the option without regard to time priority. Thus, the principal of time priority is disregarded with respect to the OFP when time priority most matters on BOX, i.e., when an order flow provider seeks to cross an

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[3] *See*, SEC, Office of Compliance Inspections and Examinations and Office of Economic Analysis, *Special Study: Payment for Order Flow and Internalization in the Options Markets* (December 2000).

[4] *"Internalization" generally refers to the practice of directing order flow by a broker-dealer to an affiliated specialist or execution by the same broker-dealer.*

[5] *See* Speech by Arthur Levitt, Chairman, SEC, entitled *"Visible Prices, Accessible Markets, Order Interaction,"* before the Northwestern University School of Law on March 16, 2000.

[6] OFP is defined as those Option Participants representing as agent Customer Orders on BOX and those non-Market Maker Participants including proprietary trading.

[7] A Market Maker is defined by BOX as an Options Participant registered with the Exchange for the purpose of making markets in option contracts traded on the Exchange and that is vested with the rights and responsibilities specified in Chapter VI of these Rules. All Market Makers are designated as specialists on the Exchange for all purposes under the Exchange Act or Rules thereunder.

order. This will encourage OFPs to submit Primary Improvement Orders at no more than a penny better than the current NBBO and then wait to see if further improvement is necessary. The ability of the OFP to match prices submitted by Market Makers in the option also will discourage Market Makers from competing for order flow.

In connection with the approval of the International Securities Exchange ("ISE") as a national securities exchange[8], several commentators expressed concern that the ISE's trading system may permit greater order internalization, largely through the ability of electronic access members (EAMs) to internalize a significant amount of order flow. The Commission nonetheless determined that the 40% member firm guarantee alleviated this concern because the remaining 60% of a facilitated order would be available for participation by the trading crowd. We, however, believe that the period of time that an order is exposed to the trading crowd is much more significant for determining whether *real* price competition is achieved rather than the percentage of the actual member firm guarantee. Therefore, we maintain that the three (3) second PIP falls short of protecting competition and public customers.

We believe that adoption of the BOX proposal will create a crossing or internalization market to the detriment of the auction process and the public customer. The principles of best execution may also be at risk where internalization occurs to such a degree that firms may not adequately represent a customer's order.

Section 11(a) and Related Regulations

Our February 14, 2003 comment letter on the BOX proposal raised several questions with respect to the impact of Section 11(a) on the new exchange. Specifically, we stated that (1) the "Effect versus Execute" exemption in Regulation 11a2-2(T) would be unavailable to Order Flow Providers participating in the PIP, and (2) the "Yielding" exemption of Section 11(a)(1)(G) and Regulation 11a1-1(T) also would be unavailable to BOX members effecting proprietary trades. We further stated that the Commission should define, or have BOX define by rule, the location of the BOX "floor" for purposes of determining on-floor and off-floor orders. None of these issues have been addressed in the revised BOX rules.

We continue to believe that associated persons of "Order Flow Providers" and "BOX Market Makers" with access to BOX through dedicated terminals or software loaded onto their PCs are in the same position as specialists, traders and brokers on floor based exchanges with respect to their time and place advantages relative to other persons and, accordingly, should be subject to the Section 11(a) restrictions applicable to exchange members. The Commission, accordingly, should define an on-floor order in an electronic market to include any order initiated by an associated person of an exchange member who has direct electronic access to the market so the public policy objectives of Section 11(a) are fulfilled. With the proliferation of electronic exchanges that lack a physical trading floor (e.g., ISE, Arca Ex, CSE and Nasdaq), there is a growing need for the Commission to define on-floor versus off-floor orders in electronic markets. We also continue to believe that the Commission should discuss the availability of (1) the Effect versus Execute exemption to order flow providers participating in the PIP, and (2) the Yielding exemption for member trading on BOX.

The following comments address specific BOX Rule proposals set forth in Amendment No. 3.

Proposed Chapter V, Section 18(g) of the BOX Rules: Price Improvement Period ("PIP")

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[8] *See* Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11388 (March 2, 2000).

Amendment No. 3 provides a new provision that permits OFPs to access the Price Improvement Period ("PIP") on behalf of public customers via a new type of order called the Customer PIP Order or "CPO." As drafted this new provision suggests that an OFP *may* but is not required to submit a CPO to the PIP.

In offering the ability to accept this order type, but not requiring it, BOX in no way can guarantee customer access to the PIP. The proposed Rule requires the OFP or directed Market Maker who has accepted the order to monitor for PIPs in that series and enter the CPO into the PIP. We are very dubious that many, if any OFPs have the technology to accomplish this feat, let alone, in the proposed three (3) second time period. We further believe that it should be the responsibility of the BOX Book to perform this function not the OFP. We also question what rights a customer may have if a CPO is entered that subsequently trades at the customer's price but fails to reach the PIP in time.

The proposed Rule also demonstrates BOX's disregard for customer booked orders. A CPO at the NBBO with time priority on the book is only eligible for execution in the PIP if it qualifies by time priority in the PIP. A similar order of a Market Maker receives "prime" status and is guaranteed a portion of the trade regardless of the time sequence in the PIP.

Lastly, and most troubling, this proposed Rule would allow or indeed require, OFP and Directed Market Makers to "trade ahead" of CPOs. For example, an OFP has accepted a CPO to buy where the CPO is at the NBBO. Subsequently, the OFP receives a marketable customer order to sell in that same series that it decides to internalize (price improve). In order to commence the PIP, the OFP must enter a proprietary order (Price Improvement Order) first. The CPO is then entered second and may or may not receive execution based on time priority. The OFP or Directed Market Maker who accepted the CPO will also have knowledge of the price and may be able to "penny" the CPO in the PIP.

Proposed Chapter VI, Section 5(b), (c): Directed Orders

BOX in its Amendment No. 3 revised the manner in which Market Makers handle orders on any agency basis renaming "customer order" as a "Directed Order." A Directed Order is defined as a Customer Order to buy or sell which has been directed to a particular Market Maker by an OFP. The OFP sends a Directed Order to BOX with a designation of the Market Maker to whom the order is to be directed. Accordingly, BOX routes the Directed Order to the appropriate Market Maker. In the proposal, the BOX indicated that the Market Maker must either: (1) submit the order to the PIP process; or (2) send the order back to BOX for placement onto the BOX Book.

The Amex questions how this process is designed to function. Does the Market Maker have thirty (30) seconds in which to act as set forth in proposed Section 5(c)(iii) or is the decision making process undefined? It is unclear from Amendment No. 3 how the Directed Order process is intended to work given the BOX's otherwise short time frames. In addition, BOX Rules are also silent on whether an OFP may direct Customer Orders to a Market Maker for any reason. Although BOX insists that Option Participants are subject to "best execution" principles, allowing an OFP to direct Customer Orders to a specific Market Maker (who may or may not be an affiliate of the OFP) for execution suggests a degree of "pre-arrangement" that may not properly account for the duty of best execution. Furthermore, permitting Directed Orders to a specific Market Maker may be anti-competitive because the incentive to compete for order flow with other

market participants is diminished.[9] We believe that this practice may discourage rigorous price competition by an internalizing firm especially in light of the three (3) second PIP process.

Proposed Chapter VI, Section 6(b), (f): Market Maker Quotations

As part of its ability to ensure the Market Maker's obligation to provide continuous two-sided markets, the BOX has proposed a Request for Quote ("RFQ") concept. A RFQ is defined as 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. The BOX proposal provides that Market Makers are required to respond to an RFQ within fifteen (15) seconds. This would seem contrary to BOX's continued assertion that three (3) seconds is sufficient time to respond to PIPs and GDOs as well as to react before a P/A Order is sent. We submit that if it only takes three (3) seconds for a Market Maker to decide if he is willing to participate in a PIP why does it take fifteen (15) seconds to decide the two-sided ten-up market? In addition, BOX's position that the longer time period is necessary because Market Makers may have to furnish a quote that they would otherwise choose not to do, even though it is their obligation as a market maker suggests that BOX market structure favors Market Makers over other market participants. Furthermore, we believe that a "fully automated" marketplace should be able to provide a rapid response to a RFQ as otherwise asserted by BOX in other contexts such as the PIP process.

Proposed Chapter V, Section 13: Unusual Market Conditions

The BOX proposes in this Rule to provide that the Options Official[10] is empowered to turn off the PIP process. Based on the nature and structure of the BOX, the Amex believes that the process of turning off the PIP process in a "fast market" should be a mandatory automatic process rather than the manual process outlined by the BOX. In the case of a "fast market," an exchange is permitted to "trade through" other markets without obligation. As a result, we question why BOX would potentially permit a firm to "trade through" the NBBO through internalization because of a manual procedure? We find it inconsistent with the apparent operation of the BOX that a manual procedure to turn off the PIP process would be required, and in addition, believe that such a manual process is inconsistent with the intention of the BOX to be "fully" automated. Accordingly, we propose that the Commission require that the BOX automate the process of turning off the PIP process when a "fast market" is declared.

Proposed Chapter VI, Section 27: Complex Orders

This section of the BOX Rules focuses on Complex Orders. Although BOX's proposal regarding Complex Orders is consistent with the current trading of Complex Orders by the options exchanges, we question whether there will exist a Complex Order Book? In addition, how will Options Participants know of such Complex Orders? Will Complex Orders be separately disseminated? Are OFPs required to monitor and execute Complex Orders like CPOs? Does BOX plan to have separate Exchange staff to monitor Complex Orders and the Complex Order Book?

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[9] There are only two (2) choices for a Market Maker that receives a Directed Order: (i) submit the order to the PIP process; or (ii) send the order to the BOX for placement onto the BOX Book.

[10] "Options Official" is an officer of BOX Regulation vested by BOX Regulation with certain authority to supervise option trading on BOX.

Options Intermarket Linkage

The Plan for the Purpose of Creating and Operating an Intermarket Options Market Linkage (the "Linkage Plan" or "Plan") was originally approved by the Commission on July 28, 2000[11] and subsequently amended on June 27, 2001,[12] May 30, 2002,[13] January 29, 2003[14] and January 31, 2003.[15] For the purpose of implementing the Linkage Plan, each options exchange filed and received Commission approval of rules governing the operation of the Intermarket Linkage (the "Linkage")[16] on January 31, 2003. In connection with this framework, BOX proposed to add Linkage Rules in order to become part of the Linkage.

BOX in connection with P Orders sent from an Away Market indicated in the discussion of Amendment No. 3 that any unexecuted portion of P Orders would be exposed to all BOX Participants for three (3) seconds at the NBBO. However, the text of the relevant Linkage Rule (Proposed Chapter VIII, Section 2(f)) states that "if the size of a P/A order or Principal Order is larger than the Firm Customer Quote Size or Firm Principal Quote Size, respectively, the Market Maker must address the order within 15 seconds to provide an execution for at least the Firm Customer Quote Size or Firm Principal Quote Size, respectively, If the order is not executed in full, BOX will move its disseminated quotation to a price inferior to the Reference Price." We question whether exposing a Principal and/or P/A Order for only three (3) seconds is enough time for market participants to react. We note as set forth above, that Eligible Market Makers have fifteen (15) seconds to execute Principal and P/A orders, and therefore, question why BOX is limiting the time period to three (3) seconds?

BOX in the proposal intends to designate a BOX Eligible Market Maker for each Eligible Options Class responsible for P/A Orders and Satisfaction Orders from away exchanges. It is unclear from the proposal how BOX will determine the BEMM and under what criteria a BOX Market Maker is able to be a BEMM. The Amex suggests that BOX clarify how this process will operate given the fact that all other options exchanges have specialist or modified specialist systems.

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[11] *See* Securities Exchange Act Release No. 43086 (July 28, 2000), 65 FR 48023 (August 4, 2000). On October 19, 1999, the Commission issued an order under Section 11A(a)(3)(B) of the Securities Exchange Act of 1934, as amended (the "1934 Act"), directing the options exchanges to file a NMS plan within 90 days to link the options markets. *See* Securities Exchange Act Release No. 42029 (October 19, 1999), 64 FR 57674 (October 26, 1999)(the "SEC Order"). The options exchanges that are Participants to the Plan include the Amex, Chicago Board Options Exchange, Inc., Pacific Exchange, Inc., Philadelphia Stock Exchange, Inc. and the International Securities Exchange, Inc. (the "options exchanges").

[12] *See* Securities Exchange Act Release No. 44482 (June 27, 2001), 66FR 35470 (July 5, 2001) ("Plan Amendment No. 1 Approval").

[13] *See* Securities Exchange Act Release No. 46001 (may 30, 2002), 67 FR 38687 (June 5, 2002)("Plan Amendments Nos. 2 and 3 Approval").

[14] *See* Securities Exchange Act Release No. 47274 (January 29, 2003), 68 FR 5313 (February 3, 2003)("Plan Amendment No. 5 Approval").

[15] *See* Securities Exchange Act Release No. 47298 (January 31, 2003), 68 FR 6524 (February 7, 2003)("Plan Amendment No. 4 Approval").

[16] *See e.g.* Securities Exchange Act Release No. 47297 (January 31, 2003), 68 FR 6526 (February 7, 2003).

If you have any questions, please contact the undersigned at (212) 306-1200 or Jeffrey P. Burns at (212) 306-1822.

Sincerely,

cc: Annette L. Nazareth
Elizabeth K. King

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