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VIA FACSIMILE and OVERNIGHT DELIVERY

September 15, 2003

Ms. Margaret H. McFarland, Deputy Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Exchange Act Release No. 48355; File No. SR-BSE-2002-15

Dear Ms. McFarland:

The Pacific Exchange, Inc. ("PCX") hereby submits its comments to the Boston Stock Exchange's ("BSE") third-amended proposal to create an electronic options trading facility called the Boston Options Exchange ("BOX").[1]

The Securities and Exchange Commission ("SEC" or "Commission") has determined that any trading practice that hampers the efficient execution of transactions, damages price transparency, interferes with the best execution of investor orders, or isolates those orders from an opportunity for meaningful interaction, warrants strict scrutiny to determine whether competitive forces alone will be sufficient to address its negative effects.[2]

In the spirit of this philosophy, the PCX strives to effect rules and trading systems designed to foster vigorous competition.[3] However, despite the goals of market centers to foster such competition and price discovery, order flow providers play a critical role in deciding where to route their customers' orders. Given the challenges of the current economic environment, order flow providers may route all or part of their order flow to a particular market center, solely to take advantage of direct and indirect economic inducements that disregard investor protections. Because these inducements, cradled in the internalization mechanism, frustrate competition and reduce order flow interaction, and because the BOX proposal would push these inducements to a logical extreme far beyond what the Commission has tolerated in the options markets, the PCX believes that the Commission has an obligation to reject the BOX proposal.

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1 See Securities Exchange Act Release No. 48355 (August 15, 2003), 68 Fed. Reg. 50813 (August 22, 2003) ("Third Amended Proposal").

2 See Securities Exchange Act Release No. 42450 (February 23, 2000), 65 Fed. Reg. 10577 (February 28, 2000).

3 See id. (The Commission expressed its belief that investors should have confidence that brokers will deal with them fairly and their orders will be routed to market centers where they will be executed efficiently at the prices that are set by vigorous competition).

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The BOX proposal, as amended, provides a model built on internalization providing the opportunity for brokers of public customers to internalize order flow without creating a market structure that encourages or ensures significant price transparency or best execution through price improvement. Indeed, the PCX believes that the proposal serves as little more than an internalization mechanism, that introduces significant risk of market fragmentation in the options marketplace. The PCX believes that the BOX internalization vehicle provides inducements to brokers to trade at that marketplace at *the* expense of frustrating key regulatory components, chiefly, price transparency and best execution. While the debate over the merits of internalization and market fragmentation continues in the equities markets, the BOX proposal, even as amended - indeed especially as amended - is inconsistent with the Commission's previous position, in the options markets, that internalization may not be added to the arsenal of those who seek to create, rather than to avoid, opportunities to advantage themselves over the interests of their customers. As has been the PCX's position with respect to payment for order flow, if *the* BOX internalization proposal is accepted, the PCX will be required *to*, for competitive reasons, adopt similar trading practices that will allow its Members to: (1) internalize orders, despite the fact that such practices will do nothing to advance the interests of the investor; and (2) conduct private auctions *in* penny increments, despite the fact that such practices will inevitably degrade the transparency and quality of the options markets. In short, if the Commission approves the BOX proposal, the options markets will collectively and rapidly become isolated dealer markets within dealer markets that will inhibit real price *discovery* and increase market fragmentation.

We hope the Commission does not force the options exchanges to make this type of choice. The Commission could decide to approach this from *a* disclosure point of view by requiring that the BOX, or any other market that chooses to operate in this manner, be prohibited from operating as a facility of an exchange and, instead, be required to register and operate as an association and, therefore, an outright and filly disclosed dealer market. The PCX believes that the preferable policy decision that best protects investors and market quality would be for the Commission to restrict the options markets from becoming a fragmented dealerized market as currently exists on the NASDAQ.

Because the BOX proposal is ostensibly an internalization mechanism, the PCX will address concerns with respect to two regulatory components related to internalization: *(i)* price transparency and (ii) best execution. In addition to the regulatory components, the PCX has specific concerns and questions about certain aspects *of* BOX's trading mechanism and, therefore, has included, as an attachment to this letter, an Appendix outlining such issues.

A. The *BOX* System Lacks Price Transparency

Price transparency is the real-time, public dissemination of quotation and *trade* information, which is key to fair and efficient securities markets, All significant market centers are required to make available to the public their best prices and the size associated with these prices![4]

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4 See, e.g., Exchange Act Rule 11Ac1-1, 17 CFR 240.11Ac1-1.

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Indeed, Congress has rejected the proposition that any market center should have the right to compete by withholding access to its information.[5] Unfortunately, internalization provides market makers and order flow providers an Opportunity to match or cross orders by providing price improvement over the National Best Bid or Offer ("NBBO") without exposing *the* orders to *the* price discovery process visible to the public. The Commission has expressed grave concern that the practice of internalization may substantially reduce the opportunity for investor orders to interact and, thereby, contribute to harmful fragmentation of the national market system. Reduced order interaction, if pervasive, may interfere with the process *of* public price transparency and detract from a market participant's obligation to provide best execution. Thus, as a result of internalization, orders remaining in the market are subject to an incomplete price discovery process, thereby causing the displayed prices to be unreliable and impairing transparency and creating greater price uncertainty. Because investors, especially retail investors, rely on displayed prices in making investment decisions, the PCX believes that displayed prices should represent the entire market's supply and demand for individual securities at any given time.

The core of the BOX system is a rapid-electronic auction termed "Price Improvement Period" or "PIP." Under the BOX proposal, an order flow provider ("OFP") may enter into the system for execution a customer PIP order accompanied by its own principal contra-side Price Improvement Order, so long as its own order is for the same size as the customer order and is priced at least $.01 better than the NBBO. The BOX will then allow a three-second PIP, during which time certain market participants may respond to the OFP's order. However, the BOX limits participation in the PIP to certain BOX Market Makers and facilitating OFP's and only allows these members to see the pending facilitation.

The PCX believes that the PIP does not offer a fair and reasonable opportunity for market participants to interact with the order and further believes that the BOX's three-second "exposure" period prior to execution is insufficient to allow market participants to assess their position-risks and the market conditions before making a reasoned decision to improve the price.[6] This is a significant departure from the PCX model where the order has already *rested* in the book for three seconds. In its third amended proposal, the BSE proposes that OFP's may access the PIP *on* behalf of customers that are not broker dealers (i.e., Public Customers) via a new order type, the "Customer PIP Order" or "CPO." The CPO *is* a customer order that provides a limit (subject to standard five (5) cent and ten (10) cent increments), but, at the discretion of the OFP, may be stepped up in penny increments through the PIP process.

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5 Testimony of Author Levitt, Chairman, SEC Concerning Market Structure Issues currently facing the Commission, before the Subcommittee on Securities, Committee on Banking, Housing, and Urban Affairs, U.S. Senate (October 27, *1999)* at 14-15.

6 The PCX believes that BOX three-second PIP period *differs* greatly from the three-second period provided *in* PCX Plus' Electronic Book Execution in that the BOX proposal is intended to foster a crossing mechanism and limit participation whereas the *PCX* Plus system encourages participation.

This proposal runs afoul of the price discovery rules in that the OFP may, but is not required to, represent the customer's true intentions with respect to the price it is willing to pay. Moreover, if customers want to trade with one another, an OFP would not be required to disseminate their true limits and they could (i) potentially miss an opportunity to match customer orders; or (ii) have their orders filled at prices inferior to that which are actually available. This is akin to the concept of reserve orders, which is contrary to the order display rules for options.[7]

The PCX urges the Commission to use its regulatory authority to assure that the BSE proposal implements price transparency on the most fair and reasonable terms. This must include both adequate time for quote responses in PIP and a fair and neutral treatment of customer orders that should not be subject to discretionary decisions of principals representing the orders.

B. The PIP's Internalization Process and Sub-MPV Price Improvement Scheme Deprive Orders of the Best Execution

The proper handling of customer orders is addressed through broker-dealers' best execution responsibilities. The duty of best execution requires a broker-dealer to seek the most advantageous terms reasonably available under the circumstances for a customer's transaction. The duty derives from agency law principles and has been incorporated into self-regulatory organization rules. Although price has been the predominant factor in determining whether a broker-dealer has fulfilled its best execution obligation, the Commission has stated that broker-dealers also should consider: (1) the size of the order; (2) the speed of execution available on competing markets; (3) the trading characteristics of the security; (4) the availability of accurate information comparing markets and the technology to process such data; (5) the availability of access to competing markets; and (6) the cost of such access.[8] Additionally, in the Order Handling Release:[9] the Commission emphasized the importance of price improvement opportunities in determining best execution. Specifically, the Commission stated that a responsible broker-dealer's regular and rigorous review should include the extent to which directed order flow would be afforded better terms, if executed in a market offering price improvement opportunities.

Internalization provides dealers with a guaranteed source of order flow, eliminating the need to compete aggressively for orders on the basis of their displayed quotations. Instead, the dealers can merely match the prices that are publicly displayed by other market centers, thereby thwarting an opportunity that the investor may have had to see his limit order executed.

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7 See, e.g., PCX Rule 6.46.

8 See Securities and Exchange Commission, Second Report on Bank Securities Activities, at 97-98, n.233 as reprinted in H.R. Rep. No. 145, 95 Cong., 1st Sess. 233 (Comm. Print 1977).

9 See Securities Exchange Act Release No. 34-37619A (September 6, 1996) ("Order Handling Release").

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Price-matching dealers, thereby, take advantage of the public price discovery provided by other market centers (which must make their best prices publicly available pursuant to Exchange Act order display obligations) but need not contribute to the process of public price discovery. Moreover, if a substantial portion of the total order flow in a security is subject to dealer price-matching arrangements, it reduces the ability of other dealers to compete successfully for order flow on the basis of *their* displayed quotations. In both cases (unfilled limit orders and disregarded dealer quotations), those market participants who are willing to participate in public price discovery by displaying firm trading interest at the best prices are not rewarded for their efforts. This creates disincentives far vigorous price competition, which, if extensive, could lead to wider bid-ask spreads, less depth, and higher transaction costs. If these occur, all orders could receive poorer executions, not just the ones that are subject to internalization and payment for order flow arrangements. Consequently, a loss of execution quality and market efficiency may not be detectable simply by comparing the execution prices of orders that are subject to such arrangements with those that are not.

The PCX believes that the BOX's improvement period in one-penny increments is discriminatory and fails to serve its stated goal of achieving best execution through price improvement. Though the BOX proposes to adopt a five *(5)* cent minimum trading increment for options trading below $3.00 and a ten (10) cent minimum for options trading at $3.00 or higher (i.e., the same minimum trading increments used by the five national options exchanges), it will allow a select group of participants to trade at penny increments during the three-second PIP process. This select group of participants, including the OFP and BOX Market Makers of such appointments, will be entitled to conduct a private thee-second auction in penny trading increments. Other BOX participants will not be permitted to join the PIP process. Moreover, the PCX believes that the penny price improvement at the BOX will have far reaching consequences on all options markets, i.e., despite the aggressiveness of a quote that creates the NBBO, BOX Market Makers and OFP's will have the last clear chance *to* internalize an order and simply price a penny better than the NBBO during the three-second PIP process. Currently, no other options market center offers its members the *right* to price improve at less than the minimum trading increment. Therefore, the PCX requests that tho Commission disallow this discriminatory practice; and forbid the BOX to *accept* orders for price improvement in increments that they cannot display.

The PCX also believes the Commission should not allow the use of penny price improvement, because such nominal price improvement will interfere with best exccution and 'unnecessarily complicate the administration of the order handling rules. The BOX supports penny price improvement, presumably because the expansion *of* the number of price points will encourage competition and will provide better prices for orders. The PCX rejects such a conclusion, because, although the PIP supports price improvement, it *is* not meaningful (i.e., docs not improve the price by the MPV), and, therefore, provides a deceptive price improvement result. Moreover, there is ample evidence from the conversion to trading in decimals, that trading in penny increments will further reduce the use of limit orders, impair transparency, and impede best execution.

The PCX is very concerned that permitting quoting and trading in penny increments, finer than the MPV increment of a \$.05 or \$.10, will create a disincentive for investors to use limit orders. The PCX also believes that penny increments may be used as a simple mechanism to circumvent time priority in an effort to effect a cross.

Therefore, the PCX proposes that, if the BOX PIP system is approved in some form, it be required to offer "meaningful" price improvement, which should be equal to the MPV permissible for that option, i.e., \$.05 or \$.10. This will ensure that the BOX participants are actually improving the NBBO within a range that is available to all market participants. Only in the event that the NBBO spread is equal to the MPV and the volume on each side of the minimum width market is equal to, or greater than, the size of the PIP order intended to be crossed, does the PCX believe it may be appropriate to use a penny increment price improvement. Even in such case, the PCX suggests that a meaningful price improvement be equal to 40% of the NBBO spread. Thus, where the NBBO spread is \$.05 and the MPV is \$.05, a BOX participant may improve an order by as little as \$.02. Where the spread and the MPV are \$.10, a BOX participant may improve an order by as little as \$.04 (40% of \$.10). The PCX submits that price improvement increments less than the ones proposed herein are not meaningful and should not be included within options markets.

Of course, the Commission could decide that penny increments are appropriate for all options markets, thereby eliminating the inequities of allowing one market to trade in smaller MPV's than Others. However, the PCX urges that the Commission reject the introduction of penny increments in the options markets at this time when: (i) OPRA's capacity to deal with the increased quotation traffic is unclear[10]; and (ii) the Commission and the industry are questioning the merits of penny increments for trading equity securities."

[10] There has been a two-year absence of any formal capacity planning, while awaiting approval of the OPRA restructure fixings. That being the case, and in view of the potential increase in message traffic, the PCX believes it is highly possible that even OPRA's expanded capacity of 52,000 mps might very well be exceeded before the Independent System Capacity Advisor will have been able to determine the collective throughput requirements. This becomes more critical given the lead time to advise the PCX data recipients of those new requirements while having SIAC identify and implement solutions for additional capacity,

[11] SEC Chairman William H. Donaldson interviewed on CNBC (May 13, 2003) expressed concern about narrowing spreads and total transaction costs associated with decimal pricing and stated, "I suspect the liquidity that used to be in the market has been severely dampened by these very narrow spreads. I think that the whole issue really needs to be looked at."

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C. Intermarket Linkage - Compatibility of BOX with Linkage Plan

While BOX proposes an anonymous order entry process where price-time priority determines the sequence in which orders are executed, participants in *the* Linkage Plan are required to submit Principal Acting as Agent ("P/A") Orders, orders for the principal account of a specialist *(or* equivalent entity on another Participant Exchange that is authorized to represent Public Customer orders), reflecting the terms of a related unexecuted Public Customer *order* for which the specialist is acting as agent; and Principal ("P") orders, for *the* principal account of an Eligible Market Maker. It is, thus, impossible for a market maker to send 3 P/A or P order to *BOX* anonymously.

There is no specialist to forward P/A or P orders from the BOX to other exchanges for execution, and there appears to be no person responsible *or* accountable for Trade-Through6 or Satisfaction Orders received from other exchanges or sent to other exchanges. In addition, BOX does not state who will make the decision to send *a* P/A order over the Linkage. Instead, the exchange itself will Forward an order on behalf of a customer. The PCX requests that BSE respond to these issues and provide descriptions as to how it intends to handle this anomaly. The PCX also suggests that the BSE work with the Linkage Operating Committee, and, where necessary, offer amendments to the Plan to be adopted, so that it may be in conformance with the Linkage Plan.

D. Conclusion

This letter and the attached Appendix represent a brief capsule of the PCX's concerns with the market structure of BOX. The Appendix lists additional comments and notes on specific details of the BOX proposal.

The PCX appreciates the Commission's consideration *of* these comments. We also appreciate the BSE's attempt to remedy deficiencies from its prior proposals, but believe that, while the third amendment provides more clarity and detail, it also highlights a system that advances internalization and market fragmentation resulting in a lack of price transparency and *a* departure from best execution principles. The PCX believes that the BSE should have an opportunity to modify its system and related rule proposal, so that it may present its alternative technology and market structure to the options marketplace without fostering increased internalization and market fragmentation. The PCX would be happy to provide any other information that the Commission may require. Please contact us with any questions you may have.

Sincerely,

Philip D. DeFeo
Chairman and Chief Executive Officer

PDD/MSS:csy

Attachment - Appendix

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cc: The Honorable William H. Donaldson
The Honorable Pad S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
Jonathan G. Katz, Secretary
Annette Nazareth, Director, Division of Market Regulation
Robert L.D. Colby Deputy Director, Division of Market Regulation
Elizabeth King, Associate Director, Division of Market Regulation
Deborah Flynn, Assistant Director, Division of Market Regulation

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APPENDIX

Analysis of Specific BOX Rules

Citation to BSE 2002-15 Amendment No. 3	PCX Comment
Ch V, Sec. 9 Pages 109, 116-117	**OPENING THE MARKET** The BSE proposal is vague with respect to how it will determine its single price opening (Sec 9(b)) on the BOX. It describes a single price opening using Market-on-Opening and limit orders combined with Market Maker Quotes. However, Section 14(c)(iii) of that section defines a "Market-on-Opening" as an order executed "at *the* best price(s) available in the market until all available volume has been traded". This appears to allow for multiple price openings and/or multiple price executions of Market-on-Opening orders. The BOX states, "Any residual volume left after part of a Market-on-Opening Order has been executed is automatically converted to a limit order at a price in which the original Market-on-Opening Order was executed." This *is* contrary to a single price opening and implies that the BOX will trade at multiple prices during the opening.

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Analysis of Specific BOX Rules (cont'd)

Ch V, Sec. 14(c)(iii) Page 121	**Order Entry** The PCX is concerned with the fact that the BOX has not satisfied in its entirety the intent of its Market-on-Opening interest from the order source. The PCX has the same concerns regarding the conversion of Market-on-Opening Orders into limit orders as it has with the conversion of BOX Top Orders to limits when they deplete the available liquidity at the NBBO. This conversion of a Market-on-Opening order could likely result in the order missing an execution should the market move away from the limit assigned *to* the order by the BOX Host and represented by the BOX. *cf.* Sec. 9(a): The BOX proposes to show market participants (docs not explain who) the Theoretical Opening Price (TOP) prior *to* the opening. The BOX *is* silent on the criteria from which this calculation will be *derived* from and who will be able to view it. *cf.* Section 9(b): The BOX proposes to calculate the "Optimum number of options contracts that could be matched at a price." The PCX is concerned with the definition of Optimum (as stated in Section 9(b)(i)) and believes that the definition is not clear as to whether it is tho maximum number or something else. The PCX believes that the definition needs to be amended for purposes of clarification. The PCX feels that the tiebreaker suggested in Section 9(b)(ii) should *be* modified to ensure that any price selected should be at a price that most benefits the customer order interest. The PCX feels that the proposed solution in Section 9(b)(iii) is not a valid remedy. The problem *is:* (i) in many cases, a closing price does *not* exist; and (ii) a closing price needs to be defined. A closing price can be a last sale or a *best* bid above the true last sale or the best offer below the true last sale. In addition, the BSE does not provide an explanation of how the closing price is calculated and what happens if there is not a closing price, which is very likely. The possibility also *arises* where the opening could be between .01 and *.05* with the least volume being at .01. This result appears unacceptable given that the BOX does not have cabinet trading in its rules. The BOX should clarify how it actually intends to treat the opening of trading and the treatment of Market-on-Opening orders on the BOX.

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Analysis of Specific BOX Rules (cont'd)

Ch V, Sec. 14(c)(2) **Page** 120	**ORDER ENTRY** The **proposal provides** that **BOX-Top orders entered** into **the BOX** Book are **executed at the best available price** in the market for the total **quantity available from any** contra **bid (offer). Any residual** volume **left after** the order has been **partially executed** is **converted to a limit** order. However, in **order to** maintain **execution due diligence, the** PCX believes **that orders** should **continue through** the price **discovery process.** **Moreover,** if the BOX **Top order is** converted **to a** limit **order by the** BOX **Host** and then the **market** moves **away** from such *limit,* the **proposal does not** specify whether **the** BOX **will.** dynamically **update** the order price to **the next** limit **or whether it** will remain **at** the **initial** limit **selected by** the **BOX Host. If** the latter *is* the case, the **PCX believes** these **orders could be negatively impacted. The PCX** also believes that the conversion to **a** limit **of** the **BOX Top** order **does** not **satisfy** the **original intent of** the order **source.**
Ch V, Sec. 14(d)(4) **Page** 122	**Order Entry** The **proposal does** not **specify how** Minimum Volume (MV) orders will **be represented. Additionally,** it **is silent on who will, be able** *to* **view** them **and/or how they might be traded through** when the minimum cannot be **satisfied.**
Ch V, Sec. 16(v) **Page** 125	**Execution and Price/Time Priority** The **proposal provides that** the **BOX will provide an uncrossing algorithm** to **calculate the price at** which the maximum **volume can be** traded. The uncrossing mechanism **employed could select a price** at **which** customers **pay** more **(sell for less) at** one of the **uncrossing** algorithm-selected **prices to** the benefit **of** professionals. The PCX finds *this* **provision** *to* **be** ambiguous **and asks** that **the** BSE **provide greater detail in order to explain how** such an **abuse** to customers' **orders will be avoided.**

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Analysis of Specific BOX Rules (cont'd)

Ch V, Sec. 16(b)(ii)(2)(b) Page 126	**Execution and Price/Time Priority** Filtering BOX In-Bound Orders: The proposal provides that, if an order is not executable at the NBBO, the BOX will internally disseminate the order at the NBBO for 3 seconds. It does not, however, define which BOX participants will be able to view the internal *message* disseminating the order, and, therefore, the proposal requires more clarity. Additionally, due to unequal access of information on the BOX, the PCX believes that this 3-second period may afford a Market Maker on the BOX the opportunity to trade ahead of other interests or to remove the hedge that would be accessed (and possibly creating the superior price) by the away market bettering the BOX.
Ch V, Sec. 16(b) Page 126	**Execution and Price/Time Priority** The proposal contains a numbering problem skipping from Section 16 (b)(ii) to (b)(vi).
Ch V, Sec. 16(b)(iv) Page 126	**Execution and Time/Price Priority** The BSE acknowledges that the BOX does not have the necessary filtering mechanism to address trade-though problems that may arise from the 3-second exposure period during which the BOX will determine if it has any non-disseminated interest at the NBBO. The PCX submits that the BOX's explanation of why it is unable to address this problem. cannot be *overcome* and believes that the proposal should have sufficient *safeguards* to prevent such violations. The PCX addresses this problem by pre-establishing the LMM's and trading crowd's willingness to step up for a trade; the PCX's system is able *to* prevent such trade-throughs and allows the LMM and the trading crowd *to* step up *for* all customers, thereby eliminating a potential for favoritism with respect to any customer at any time. The PCX believes that the BSE should rework its proposal to offer the same protections and avoid the potential for favoritism.

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Analysis of Specific BOX Rules (cont'd)

Ch V, Sec. 18(g)(iv) Pages 130 - 131	**THE PRICE IMPROVEMENT PERIOD "PIP"** The proposal provides that a CPO cannot be traded on the opposite side of the Primary Improvement Order "PIO." The PCX believes that this process limits the Public Customer from getting the best prices and allows Market Makers the opportunity to trade in front of customers who have non-displayed superior limits. Example: NBBO is Bid $1.00 offered at $1.15 BOX is Bid $1.00 offered at $1.15 CPO is Bid $1.00 (CPO Book Reference Price) plus a CPO PIP Reference Price of $1.10 PIP order is entered to pay $1.05 PIO order is entered to sell at $1.02 The trade is completed at $1.02 with the Customer Price Improvement Order getting nothing on its willingness to pay $1.10. As a result of this exclusion, the customer with the better limit and time priority was disadvantaged because of allowances under the proposed PIP rules.
Ch V, Sec. 18(g) Pages 130 - 131	**The Price Improvement Period ("PIP")** The CPO order type requires that, if it is submitted to the PIP, it be submitted through an OFP. This requires OFP's to have the capacity to support CPO orders. Because OFP's have varying levels of sophistication with regard to electronic processes, the PCX believes that OFP's should be subject to a certification process whereby they can demonstrate that they have the ability and capacity to support these order types, ensuring that CPO orders are treated equally, regardless of the OFP.

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Analysis of Specific BOX Rules (cont'd)

Ch V, Sec. 18(e) Page 129	**The Price Improvement Period ("PIP")** The BOX will not have a PIP unless three (3) or more Market Makers are quoting at the time an Options Participant submits a Primary Improvement Order to initiate a PIP. The proposal does not specify, however, whether a CPO counts as a Market Maker for the purpose of this calculation. The PCX submits that it should delineate this to prevent disadvantaging the CPO. The PCX cannot determine what procedures are invoked if less than three participants are present.
Ch V, Sec. 18(g) Rage 130	**The Price Improvement Period ("PIP")** The proposal will not allow all orders present at the BOX to enter or improve the PIP. The PCX believes that denial of such access to these orders is unfair and inconsistent with the requirements that the Commission has previously required of the PCX in regards to its launch of PCX Plus.
Ch V, Sec. 18(g)(i) Page 130	**The Price Improvement Period ("PIP")** The proposal does not specify how many increments a CPO may be stepped up. The PCX believes it to be conceivable that two CPOs on the opposite sides of the market could desire to trade at a crossed price, but the BOX would not allow them to match off with each other at a mutually beneficial price. Without an appropriate matching system for these types of orders, the BOX creates an internally crossed or locked market with customer interest.

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Analysis of Specific BOX Rules (cont'd)

Sec. 18(g)(iii) Page 131	**The Price Improvement Period ("PIP")** The proposal provides that, in order for the CPO to be eligible for participation in a PIP, the BOX Book Reference Price for a CPO must be equal to the NBBO at the time a PIP commences. This limitation may result in many CPO's being traded through as a result of the PIP during which the CPO was prevented from participating. For example, if a CPO Book Reference Price is $2.00 bid, the NBBO is $2.05 bid, and the CPO order has a CPO PIP Reference Price of $2.10, the BOX would not permit the CPO to participate in the PIP. Therefore, the PIP could execute the PIP order at any price between $2.06-$2.09, trading through the CPO PIP Reference Price. The PCX believes that the BOX's PIP process, allowing one order to fill at prices less than that submitted on behalf of a customer order, should be modified,
Sec. 19 Page 132	The BOX proposal. limits the Market Maker participation in the PIP to the Market Maker Prime. The PCX believes that all Market Makers who are active in a series (but may not be at the NBBO) should be entitled to participate in the PIP process.
Ch V, Sec. 18(g)(iv) Page 131	**The Price Improvement Period ("PIP")** The proposal states that a CPO can only participate if it is on the contra side of a PIP. This could allow the market to trade in front of customer interest, For example, if the CPO Book Reference Price is $2.05 bid, the NBBO is $2.05 bid, and the CPO order has a CPO PIP Reference Price of $2.10, it would be excluded from the PIP if a PIP order was entered to buy for $2.10 and a PIP ensued that resulted in a PIP trade consummated at $2.06. This then would allow firms to place and trade their orders in front of other customers.

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Analysis of Specific BOX Rules (cont'd)

Ch V, Sec. 18(g)(vi) Page 131	**The Price Improvement Period ("PIP")** The BOX proposal provides that the terms of the CPO cannot change during a PIP. However, the rules permit a Market Maker to improve its quote, thereby entitling it to a time and place advantage. Because the BOX proposal contemplates that an OFP can be considered a Market Maker, the PCX believes that this may frustrate the spirit of Section 11(a) of the Exchange Act. This also raises Manning issues in that the Market Maker may have knowledge of an unexecuted customer limit order and continue to trade on the BOX for its own account at prices that might satisfy the customer's limit order. The PCX is concerned that interested parties within BOX are promoting the BOX mechanism that is inconsistent with the proposed rules of the BOX. The rule in question is the handling of the CPO PIP Reference Price. The BOX rules state that the CPO may not change the terms of its submission to the PIP; however, the PCX believes that individuals who have taken the opportunity to comment on the proposal, may have misunderstood this provision. The PCX would appreciate an opportunity to fully comment on this provision when the BSE mends it to include the indicia of detail that would make it clear and remove any ambiguity.
Ch V, Sec. 18	**The Price Improvement Period ("PIP")** Prior knowledge of an order: The proposal requires that a PIP have prearranged communication, thereby giving the Market Maker a time and place advantage over executions that they may receive on other exchanges.

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Analysis of Specific BOX Rules (cont'd)

Ch V, Sec. 18	**The Price Improvement Period.("PIP")** OFP's or Market Makers with prior knowledge could make anticipatory hedges in underlying stocks, indices or other options. These are clearly against other exchanges' rules and are deemed to be front running. Since OFP's are guaranteed trade participation and allowed a second and third look, they may be incentivized to initiate their hedges before the rest of the market participants have a chance to compete for their hedge. The BOX is silent on all rules regarding front running options orders involved in the PIP process. In the BOX road show presentation, the BSE demonstrated how orders interact during the PIP process. In one example, the NBBO is $2.05 Bid for 10 at $2.15 and the BOX market is $2.00 at $2.15. If the OFP were to have a sell order larger than the NBBO bid, it could send an order to the other market to lower the bid to $2.00 and then use the PIP process to cross the remainder of the trade at $2.01. The BOX rules are silent about OFP's or Market Makers taking action by abusing Linkage or mother order routing device to change away markets prior to initiating a PIP, to the detriment of the sell order.
Ch V, Sec. 18	**The Price Improvement Period ("PIP")** With no minimum on the size of an order eligible for a PIP, there exists the possibility that an active series could have a frozen market while multiple PIP's overlap or queue.
Ch V, Sec. 18	**The Price Improvement Period ("PIP")** In the PIP, an introducing firm can keep improving its price. The PCX believes that this could provide an incentive to price less aggressively and improve the price only if necessary. In all other exchanges' crossiug mechanisms with guaranteed participation percentages, the introducing firm (OFR) is at risk of a market participant paying more or selling for less than the firm and shutting it out of participation. Thus, the firm is incented to price aggressively from the beginning, and Market Makers are given incentive to step past (i.e., price better) the firm to garner a greater share,

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Analysis of Specific BOX Rules (cont'd)

Ch V, Sec. 19(c) Page 133	**Market Maker Prime** The proposal provides that an Improvement Order of the Market Maker Prime will bave a guaranteed trade allocation of at least one-third of any portion of a PIP Order remaining at the order's limit price. The PCX believes that this allocation is likely *to* guarantee Market Makers' and OFP's' trade participation rights in front of customer orders (CPO PIP Reference Price).
Ch V, Sec. 19(e) Page 133	**Market Maker Prime** The PCX believes that the BOX proposal requires greater specificity with respect *to* the treatment of a non-PIP Market Maker when such Market Maker improves its quote during the 3-second PIP. The PCX believes that the BOX should expand its PIP process to all market participants, so that all such orders may interact with the PIP orders. For example, if the NBBO is $2.00 at $2.15 and a PIP is initiated with a seller at $2.01, the proposal does not state what will happen if, during the 3-second period, a Market Maker who was quoting $1.95 bid steps up to bid $2.10. It appears that this quote would not be included in the PIP because it was not at the NBBO prior to the commencement of the PIP. The PCX believes that the exclusion of *this* Market Maker will preclude the customer from being filled at the best price. The proposal also does not address what happens when the NBBO changes during the PIP. At the conclusion of the PIP, the BOX cross may print outside NBBO. The BOX rules are silent as to how they intend to handle this situation.
Ch V, Sec. 20(c) and (d) Page 134	**Obvious Error** The BOX proposal makes a reference to the exchange with the "most liquidity." Because that phrase can be defined in a number of ways, i.e., the most volume YTD or MTD, or Market *Share*, the PCX believes that the proposal needs greater specificity.

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Analysis of Specific BOX Rules (cont'd)

Ch V. Sec. 27(b)(ii) Page 142	**Complex Orders** The proposal provides that the option leg of a stock and option order has priority over bids and offers established in the marketplace by orders and Market Maker quotes that are no better than the price of the option leg. This provision appears contrary to price and time priority rules of other options exchanges. The PCX believes that the proposal would allow a market participant *to* abusa the BOX by representing that a trade would have an options leg and a stock leg. In such cases, the order would have first-in-time status in front of other orders at the same price. The proposal does not state what would happen if the order on the stock leg was canceled or removed from the tape. There is also no mention of how much stock must accompany the options trade in order to allow it to be first in time. As proposed, 10,000 calls could trade against 100 shares of stock and get first in priority status.
Ch I, Sec. 1(21) Ch VI, Sec. 5(c) Rage 3, 13-21	**Definitions (Directed Order)** **Obligations of Market Makers** The BOX proposes to introduce Directed Orders, which allows Market Makers to receive and handle orders on an agency basis. The proposal affords the Market Maker discretion *to* view the Directed Order for an unspecified period of time before it decides whether to: (i) *to* allow the order to participate in a PIP process; or (ii) send the order to the BOX Book on a selective basis. The PCX submits that the SEC has never permitted an options Market *Maker* to have such discretion and believes the suggested process for this order type is analogous to allowing different step-up parameters based on firm identity. If the Commission is inclined to permit this feature on the BOX, the PCX believes that the proposal should include objective criteria outlining the basis upon which the Market Maker would exercise its discretion.

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Analysis of Specific BOX Rules (cont'd)

Ch. VI, Sec. 6(g) Page 154	**Market Maker Quotations** The BOX proposal does not contain a provision that prohibits an Option Participant (i.e., non-Market Maker) from entering multiple two-sided bids and offers into the system, as principal or agent for the account or accounts of the same beneficial owner(s), in a manner that such participant or beneficial. owner is effectively operating as a Market Maker by holding itself out as willing to buy and sell such option contracts on a result or continuous basis. The PCX believes that this conduct should be expressly prohibited to prevent Option Participants from circumventing the registration and *trading* obligations of Market Makers.
Ch. VI, Sec. 5 Pages 146 - 247	**Obligations of Market Makers** The quoting obligations of Market Makers *are* vague in that they could leave the BOX in a position where they are not maintaining any quote in the market for an extended period of time. For example, if a Market Maker trades 10 issues all having the same number of series, then that Market Maker would only have *to* quote *72% (80% of 90%)* of the series under its primary. Alternatively, when a Market Maker trades 10 issues and *9* of the 10 issues have 12 series each, and the tenth issue has 300 series (e.g., QQQ), the ratio of obligated series is much less *than 72% (9* issues *X* 12 series x 80% = 86.4 quoted series). The 87 series only represents 87/ 408 or 21.32% of all series under that Market Makers Primary appointment. Thus, in this example, a single BOX Market Maker could legally not quote 78% of the series under their responsibility. The PCX submits that this *is* not beneficial to the marketplace and will only contribute to the minimal obligations for participants that want to internalize order-flow under the guise of a Market Maker.

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Analysis of Specific BOX Rules (cont'd)

Ch. XII, Sec. 2 - 6 Page 213 -225	**Intermarket Linkage Rules** The PCX believes that the BOX Linkage provisions are vague, incomplete, and inconsistent with *the* Intermarket Linkage Plan, and, therefore, the PCX believes that the BOX should not be approved as a Linkage Participant until it properly amends the Linkage Plan to remedy the outstanding Linkage concerns. For example, there is no specialist to forward P/A or P orders from *the* BOX to other exchanges for execution, and there appears to be no person responsible or accountable for Trade-Throughs or Satisfaction Orders received from other exchanges or sent to other exchanges. . The BOX filing, by describing the Exchange as the entity that will forward customer orders as P/A orders through the Linkage, does not meet the Limitations on P/A Order Access as described in Section 8 (b)(ii) of the Plan. In addition, the Linkage Plan allows block size orders to trade through the NBBO so long as displayed customer orders that *are* traded through receive Satisfaction at the Block Price. However, the BOX has not described how *a* Block size trade resulting from a PIP priced in a penny increment will satisfy any orders it may trade through, *since* the other Participating Exchanges do not trade at values other than at an eligible MPV (either $.05 or $.10).
Miscellaneous	The BOX road show presentation demonstrates that BOX participants will have the ability *to* see market information (Best Five Limits) on an internal network *that* may be on a timelier basis than information provided to OPRA. The proposal does not provide enough detail on this issue, and the PCX, therefore, requests greater specificity in order to determine whether this issue should be addressed by BOX. PCX believes that BOX needs to demonstrate that it will operate consistent with the OPRA Plan.
Miscellaneous	The PCX believes that the proposal should include provisions relating to Cabinet trading and how the BOX intends to trade them. It would be possible to trade at a price of $.01 in the PIP and such trade would be equivalent to a cabinet trade. Cabinets are cleared *and* reported differently to OCC, and are not reported *to* OPRA.

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RE: PCX Comment to SR-BSE-2002-15, Amendment No. 3

Please see attached.