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AMERICAN STOCK EXCHANGE®
Equities Options ETFs

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

American Stock Exchange
86 Trinity Place
New York, NY 10006-1872
T 212 306 1200
F 212 306 1152
michael.ryan@amex.com

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OFFICE OF THE SECRETARY

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 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.

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").

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 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.

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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.

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")

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

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

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