

that entirely replaced the original rule filing and Amendment No. 1.<sup>4</sup> The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The BSE proposes to create a new electronic options trading facility of the Exchange, called the Boston Options Exchange ("BOX"). The text of the proposed rule change is available for inspection at the Office of the Secretary, the BSE, the Commission's Public Reference Room, and on the Commission's Internet Web site (<http://www.sec.gov/rules/sro/shtml>).

### **II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change**

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

#### **A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change**

##### **1. Purpose**

The BSE proposes to establish rules for BOX,<sup>5</sup> a new exchange facility, as that term is defined in Section 3(a)(2) of the Act.<sup>6</sup> BOX would be operated by Boston Options Exchange Group, LLC ("BOX LLC").<sup>7</sup> BOX would administer a fully automated trading system for standardized equity options intended for the use of Options Participants.<sup>8</sup> It

would conduct an auction market similar to the ones conducted by the options exchange markets currently in operation, although the BOX auction would occur electronically and not on a floor. BOX would provide automatic order execution capabilities in the options securities listed or traded on the BSE.

The BSE intends to establish BOX as an options market where orders from all types of market participants may interact directly with each other on a price/time priority basis. Through a specific process called the Price Improvement Period ("PIP"),<sup>9</sup> BOX would attract orders and subject them to price improvement and real price competition without which they would otherwise simply be executed at the NBBO. BOX would offer a price/time priority based limit order book where any Public Customer<sup>10</sup> or broker-dealer market participant could submit orders (post prices) or take liquidity. It would also provide a limited facility for Order Flow Providers<sup>11</sup> to interact with their own order flow but only at prices better than the best bid or offer on the market; and a true opportunity for Market Makers<sup>12</sup> to step in and compete for those orders quickly and anonymously.

a. Summary of BOX Trading Rules. (i) Low Barriers to Trading Access. BOX would have multiple and competing market makers rather than a specialist driven system. There would be no designated specialists, primary market makers, or lead market makers with authority to control trading in a particular options class. Market making in an options class on BOX would be open to all qualified Options Participants who are approved by the

Chapter I, *General Provisions*, Sec. 1(a)(39) (definition of "Options Participant").

<sup>9</sup> See proposed BOX Rules, Chapter V, *Doing Business on BOX*, Sec. 18, *Price Improvement Period*.

<sup>10</sup> The term "Customer" means either a Public Customer or a broker-dealer. The term "Public Customer" means a person that is not a broker or dealer in securities. All Customer orders must be submitted through an approved BOX Options Participant. See proposed BOX Rules, Chapter I, *General Provisions*, Sec. 1(a)(19) (definition of "Customer") and Sec. 1(a)(49) (definition of "Public Customer").

<sup>11</sup> The terms "Order Flow Provider" or "OFP" mean those Options Participants representing as agent Customer Orders on BOX. See proposed BOX Rules, Chapter I, *General Provisions*, Sec. 1(a)(45) (definition of "Order Flow Provider").

<sup>12</sup> The term "Market Maker" means an Options Participant registered with the Exchange for the purpose of making markets in options contracts traded on the Exchange and that is vested with the rights and responsibilities specified in Chapter VI of these proposed BOX Rules. All Market Makers are designated as specialists on the Exchange for all purposes under the Act. See proposed BOX Rules, Chapter I, *General Provisions*, Sec. 1(a)(31) (definition of "Market Maker").

Exchange as Market Makers.<sup>13</sup> All appointed competing Market Makers would be responsible for ensuring basic liquidity. BOX has invested heavily to acquire the necessary processing capacity to rapidly and efficiently process the messaging traffic that multiple market making would generate as BOX believes this would significantly intensify competition. This competition would encourage tighter spreads and better pricing to the ultimate advantage of the investor. Further, in the spirit of maintaining a flat and open marketplace, BOX would limit Market Makers' privileges within their appointed classes to the ability to maintain orders on all series and to the opportunity to participate in PIP auctions. BOX Options Participants, whether Market Makers or Order Flow Providers, or both, would not be required to obtain membership in the BSE, nor to lease trading rights from any member ("seat holder") of the BSE. Market Maker Participants would be required to register as an Options Participant, obtain approval from the BSE and pay a modest annual access fee for trading rights and a low execution fee per contract.<sup>14</sup>

In addition, as BOX would be fully automated and without a central trading floor, Participants would have to access BOX from "remote" locations. The reduction in fixed costs and the barriers to entry would give rise to a wider variety of market participants than heretofore seen, resulting in fiercer competition to the ultimate advantage of the Customers who use BOX.

(ii) Anonymous Central Order Book with Price/Time Priority. All orders on BOX would be entered on the BOX Central Order Book ("BOX Book").<sup>15</sup> Only prices and quantities would be displayed to all trading Participants, maintaining full anonymity with regard to the ownership of each order. With only minor exceptions, all orders would be matched on a strict price and time priority algorithm. This will result in better pricing since the price and time priority algorithm gives a strong incentive to trading Participants to post their very best prices rapidly. There would be no opportunity to "step up

<sup>13</sup> See proposed BOX Rules, Chapter VI, *Market Makers*, Sec. 4, *Appointment of Market Makers*.

<sup>14</sup> The BSE intends to file under separate cover a proposed rule change regarding BOX related fees, pursuant to Section 19(b) of the Act, 15 U.S.C. 78s(b).

<sup>15</sup> The term "Central Order Book" or "BOX Book" means the electronic book of orders maintained by the BOX Trading Host. See proposed BOX Rules, Chapter I, *General Provisions*, Sec. 1(a)(12) (definition of "Central Order Book").

<sup>4</sup> See Letter from George W. Mann, Jr., Executive Vice President and General Counsel, BSE, to Annette Nazareth, Director, Division, Commission, dated January 8, 2003.

<sup>5</sup> The term "BOX" means the Boston Options Exchange or Boston Stock Exchange Options Exchange, an options trading facility of the Exchange under Section 3(a)(2) of the Act. See proposed BOX Rules, Chapter I, *General Provisions*, Sec. 1(a)(6) (definition of "BOX").

<sup>6</sup> 15 U.S.C. 78c(a)(2).

<sup>7</sup> The founding members of BOX LLC are the BSE, the Bourse de Montreal, Inc., and Interactive Brokers Group, LLC.

<sup>8</sup> The term "Options Participant" or "Participant" means a firm or organization that is registered with the Exchange pursuant to Chapter II of the proposed BOX Rules for purposes of participating in options trading on BOX as an "Order Flow Provider" and/or "Market Maker." See proposed BOX Rules,