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*Comments are particularly invited on:* Whether this information is necessary for the proper performance of functions of OPM, and whether it will have practical utility; whether our estimate of the public burden of this collection of information is accurate, and based on valid assumptions and methodology; and ways in which we can minimize the burden of the collection of information on those who are to respond, through the use of appropriate technological collection techniques or other forms of information technology.

For copies of this proposal, contact Mary Beth Smith-Toomey on (202) 606-8358, FAX (202) 418-3251 or e-mail to [mbtoomey@opm.gov](mailto:mbtoomey@opm.gov). Please be sure to include a mailing address with your request.

**DATES:** We will consider comments received on or before October 21, 2003.

**ADDRESSES:** Send or deliver written comments to: Leah Meisel, Deputy Associate Director for Talent and Capacity Policy, U.S. Office of Personnel Management, 1900 E Street NW., Room 6551, Washington, DC 20415.

Office of Personnel Management.

**Kay Coles James,**  
Director.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-48355; File No. SR-BSE-2002-15]

### Self-Regulatory Organizations; Notice of Filing of Amendment No. 3 to the Proposed Rule Change by the Boston Stock Exchange, Inc. Establishing Trading Rules for the Boston Options Exchange Facility

August 15, 2003.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on August 15, 2003, the Boston Stock Exchange, Inc. ("BSE" or "Exchange") filed with the Securities and Exchange

Commission ("Commission") Amendment No. 3 to the proposed rule change, as described in Items I, II, and III below, which Items have been prepared by the Exchange. The BSE submitted the proposed rule change to the Commission on October 31, 2002. On December 18, 2002, the BSE filed Amendment No. 1 that entirely replaced the original rule filing.<sup>3</sup> On January 9, 2003, the BSE filed Amendment No. 2 that entirely replaced the original rule filing and Amendment No. 1.<sup>4</sup> Amendment No. 2 was published in the **Federal Register** on January 22, 2003 ("BOX Proposing Release").<sup>5</sup> The Commission received 43 comment letters.<sup>6</sup> In response to the concerns

<sup>3</sup> See Letter from George W. Mann, Jr., Executive Vice President and General Counsel, BSE, to Annette Nazareth, Director, Division of Market Regulation ("Division"), Commission, dated December 18, 2002 ("Amendment No. 1").

<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 ("Amendment No. 2").

<sup>5</sup> Securities Exchange Act Release No. 47186 (January 14, 2003), 68 FR 3062 ("BOX Proposing Release").

<sup>6</sup> See Letters to Jonathan G. Katz, Secretary, Commission, from Paul Fred, CEO, PFTC Trading, LLC, dated January 24, 2003; Myron Wood, Statistician, Changes, LLC, dated January 30, 2003; Mike Ianni, dated February 2, 2003; Shawn Gibson, Senior VP, Equity Derivatives, Scott & Stringfellow, dated February 6, 2003; CSFB Next Fund, Inc., Interactive Brokers Group, LLC, LabMorgan Corporation, Salomon Brothers Holding Company, Inc., UBS (USA) Inc., dated February 6, 2003; Sallerson-Troob, LLC, dated February 9, 2003; Christopher D. Bernard, dated February 10, 2003; George Papa, Director, PEAK6 Investments, dated February 10, 2003; Frank Hirsch, CBOE Market Maker, dated February 10, 2003; Richard W. Cusack, Operations Manager, Sparta Group of Chicago, LP, dated February 11, 2003; Paul Britton, CEO, MAKO Global Derivatives LLC, dated February 11, 2003; John Colletti, Samuelson Trading, dated February 11, 2003; Robert S. Smith, Chief Technology Officer, GETCO, LLC, dated February 11, 2003; Phillip Sylvester, CBOE Market Maker, dated February 11, 2003; Keith Fishe, DRW Holdings, LLC, dated February 11, 2003; Daniel C. Bigelow, president, Monadnock Capital Management, dated February 11, 2003; Erich Tengelsen, Chicago Trading Company, dated February 12, 2003; Thomas Peterffy, Chairman, David M. Battan, Vice President and General Counsel, Interactive Brokers LLC, dated February 12, 2003; John T. Thomas, Van Der Moolen USA LLC, dated February 12, 2003; Robert C. Sheehan, Electronic Brokerage Systems LLC, dated February 12, 2003; Thomas J. Murphy, TJM Investments, LLC, dated February 12, 2003; Meyer S. Frucher, Chairman and Chief Executive Officer, Philadelphia Stock Exchange, Inc., dated February 12, 2003; Michael Resch, dated February 12, 2003; Todd Silverberg, General Counsel, Susquehanna International Group LLP, dated February 12, 2003; Michael J. Simon, Senior Vice President and Secretary, International Securities Exchange, Inc. ("ISE"), dated February 12, 2003; Juan Carlos Pinilla, Managing Director, Equity Derivatives Trading, JP Morgan, dated February 12, 2003; Marc J. Liu, Options Specialist, AGS Specialist Partners, dated February 12, 2003; Jan-Joris Hoefnagel, President, Optiver Derivatives Trading, dated February 13, 2003; Steve Tumen, CEO, and David

raised in the comment letters and discussions with Commission staff, the BSE filed Amendment No. 3. The Commission is publishing this notice to solicit comments on Amendment No. 3 from interested persons.

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

As described in the BOX Proposing Release, the BSE proposes to create a new electronic options trading facility of the Exchange, called the Boston Options Exchange ("BOX"). The text of Amendment No. 3 to 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

As discussed in detail in the BOX Proposing Release,<sup>7</sup> the BSE proposes to

Barclay, General Counsel, Equitec Group, LLC, dated February 14, 2003; Michael J. Ryan, Jr., Executive Vice President & General Counsel, American Stock Exchange LLC ("Amex"), dated February 14, 2003; Williams J. Brodsky, Chairman and Chief Executive Officer, Chicago Board Options Exchange, Inc. ("CBOE"), dated February 14, 2003; Paul Roesler, Lead Market Maker, Pacific Exchange, Inc. ("PCX"), dated February 14, 2003; Andrew W. Lo, dated February 15, 2003; Nicholas Bonn, Executive Vice President, State Street Global Markets, LLC, dated February 21, 2003; Robert Bellick, Christopher Gust, Wolverine Trading, LLC, dated February 27, 2003; Philip D. DeFeo, Chairman and CEO, PCX, dated February 27, 2003; Thomas N. McManus, Executive Director and Counsel, Morgan Stanley, dated March 3, 2003; Philip C. Smith, Jr., Vice President, Options, The Interstate Group, dated March 7, 2003; Bryan Rule, dated March 11, 2003; Michael J. Ryan, Jr., Executive Vice President & General Counsel, Amex, dated March 13, 2003; David Hultman, dated March 25, 2003; Stephen D. Barret, dated March 26, 2003; and John Welker, June 11, 2003.

<sup>7</sup> See *supra* note 5.

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

establish rules for BOX,<sup>8</sup> a new exchange facility, as that term is defined in Section 3(a)(2) of the Act.<sup>9</sup> BOX would be operated by Boston Options Exchange Group, LLC ("BOX LLC"). BOX would administer a fully automated trading system for standardized equity options intended for the use of Options Participants.<sup>10</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.

In Amendment No. 3, the BSE has made certain minor changes, like renumbering and fixing typographical errors. In addition, the BSE also proposes the following, more substantive changes to the proposed rules set forth in the BOX Proposing Release. For ease of reference, the BSE has referenced each section or paragraph, which has been added to, or changed, in any substantial way.

*Proposed Chapter I, Section 1* The BSE proposes to add or amend the following definitions:

*Proposed definition (21)* has been amended to state "The term 'Directed Order' means any Customer Order to buy or sell which has been directed to a particular Market Maker by an OFP." This definition was added in order to clarify that an OFP may send an order to BOX and have it routed to a particular Market Maker for an opportunity for price improvement pursuant to proposed Chapter VI, Section 5.

*Proposed definition (46)* has been amended to state that "The terms 'Order Flow Provider' or 'OFP' mean those Options Participants representing as agent Customer Orders on BOX and those non-Market Maker Participants conducting proprietary trading." This definition was amended in order to clarify that OFPs may conduct business with the public on an agency basis and may also conduct a proprietary trading

business or may conduct only either business.

*Proposed definition (54)* has been amended to state that "The term 'Request for Quote' or 'RFQ' shall mean 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 RFQ contains only the series symbol and quantity and is broadcast to all Participants." This definition was added in order to delineate the meaning of the RFQ function pursuant to its use under Chapter VI, Section 6(b)(ii).

*Proposed Chapter II, Section 2(b)*—In order to eliminate any confusion that may have arisen from the interpretation of this rule regarding customer-carrying firms, the BSE has amended this paragraph so that Options Participants must be registered as broker-dealers. Additionally, as also discussed below under proposed Chapter XI, the BSE has clarified that its sales practice rules ("Doing Business with the Public") apply only to those Options Participants who are permitted under the BOX Rules to deal directly with the public, that is, OFPs. It was never the intention that participation in BOX be limited to customer-carrying firms.

*Proposed Chapter II, Section 2(e), (g), and (h)*—In several places, the BSE has added requirements regarding Options Participants. Primarily for the purpose of examinations, the BSE has set forth requirements for Options Participants who, though they must be U.S. registered broker-dealers, do not maintain an office within the United States and are responsible for preparing and maintaining financial and other reports required to be filed with the Commission, BOXR, and the Exchange. In such cases, the Options Participant must maintain all such documents in English and U.S. dollars, provide an individual fluent in English and knowledgeable in securities and financial matters, and reimburse the Exchange for any expense incurred in connection with examinations of the Participant to the extent that such expenses exceed the cost of examining a Participant located within the continental United States.

Also, the BSE has set forth that Options Participants must have as the principal purpose of being an Options Participant the conduct of a public securities business. These requirements are consistent with those in place on other options exchanges and which have been previously approved by the Commission.<sup>11</sup> In light of the current

focus in the market place on corporate governance, and non-U.S. based market participants, the BSE has determined that these provisions would serve to add important investor protections to the BOX Market, while not limiting or inhibiting the low barriers to access unique to BOX vis a vis the other options markets.

*Proposed Chapter V, Section 9*—The BSE realizes that in this section it had made a typographical error and used the term "Market-On-Open" Order, while in Chapter V, Section 14, the same order is called a "Market-On-Opening" Order. The BSE has corrected this error so that the name of the order in Section 9 is also "Market-On-Opening." In addition, the BSE notes that it has not changed any other parts of this section, including paragraph (b), which states "BOX will determine a single price at which a particular series will be opened."

*Proposed Chapter V, Section 14*—In this section, the BSE has changed the name of the Market Order. Formerly, the BSE proposed to define a Market Order as an order, which is "entered into the BOX Book and executed at the best price available in the market for the total quantity available from any contra bid (offer). Any residual volume is automatically converted to a limit order at the price at which the original market order was exhausted." Since this definition differs from the commonly used concept of "market order" in the U.S.-based options market, the BSE has changed the name of this order type to "BOX-Top" Order, to eliminate the possibility of confusion on the part of investors and other options market participants. The BOX Market will not have a "market order," as that term is typically used, that can be executed at successive price levels. A BOX-Top Order will not receive a price inferior to that which a typical market order would have received in the BOX Market. Moreover, as a result of BOX's trade-through filter process (see discussion below of Chapter V, Section 16(b)) and the Intermarket Linkage, no BOX-Top Order will receive a price inferior to the national best bid or offer ("NBBO"). Indeed, due to BOX's Price Improvement Period mechanism, orders submitted to BOX have the potential to be executed at a price superior to the NBBO.

In addition, the BSE has clarified the definition of Market-on-Opening Order by adding "any residual volume left after part of a Market-on-Opening Order has been executed is automatically converted to a limit order at the price at which the original Market-on-Opening Order was executed."

<sup>8</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. Proposed BOX Rules, Chapter I, General Provisions, Section 1(a)(6) (definition of "BOX").

<sup>9</sup> 15 U.S.C. 78c(a)(2).

<sup>10</sup> The term "Options Participant" or "Participant" means a firm, or organization that is registered with the Exchange pursuant to Chapter II of the BOX Rules for purposes of participating in options trading on BOX as an "Order Flow Provider" or "Market Maker". See Proposed BOX Rules, Chapter I, General Provisions, Section 1(a)(39) (definition of "Options Participant").

<sup>11</sup> See e.g., ISE Rule 301.

*Proposed Chapter V, Section 16(b)*—The BSE has added to this section rules governing the BSE's proposed filtering of in-bound orders to prevent executions on the BOX at prices inferior to the NBBO. All in-bound orders to BOX from Customers as well as inbound Principal ("P") and Principal as Agent ("P/A") orders received via the InterMarket Linkage will be filtered by BOX prior to entry on the BOX Book in order to ensure that these orders will not execute at a price outside the current NBBO ("trade-throughs"). In this manner, the BSE believes that it has added an extra level of efficiency to its BOX trading engine, which will serve to enhance both the best execution of orders as well as BOX's participation in the Intermarket Linkage. The filter will operate by analyzing each in-bound Customer Order, P Order or P/A Order as follows:

Step 1: The filter will determine if the order is executable against the NBBO (by definition the answer is "yes" in the case of a BOX-Top Order).

- If NO, then the order would be placed on the BOX Book.
- If YES, then the filter will proceed to Step 2.

Step 2: The filter will determine whether there is a quote on BOX, which is equal to the NBBO.

- If NO, then the order is exposed on the BOX Book at the NBBO for a period of three seconds, during which time any Options Participant may execute against the order. At the conclusion of the three-second period, if there is any remaining quantity, the filter will proceed to Step 3.
- If YES, then the order would execute against the quote/orders on the BOX Book.

Step 3: If there is any unexecuted quantity at the end of three seconds, then:

- In the case of Public Customer orders, a P/A Order will be generated and sent to the away exchange that is displaying the NBBO.
- In the case of P and P/A Orders, any unexecuted portion will be returned to the originating exchange.

In determining the length of time for an exposure period for orders which might otherwise trade through NBBO, but are "caught" by the filter, the BSE has determined that three seconds is ample time, in an electronic trading environment, for an Options Participant to match the NBBO in those instances in which BOX is not quoting at the NBBO. This exposure period will give all the BOX Market Makers, as well as Participants in general, an opportunity to trade at the NBBO should they choose to do so.

*Proposed Chapter V, Section 17 (c)*—The BSE has eliminated the provision, which imposed a surcharge on Options Participants that submitted orders on behalf of broker-dealers in excess of two times the number of Public Customer contracts they executed in a given month. Similar to the rationale for the elimination of a charge to Market Makers set forth in Chapter VI, Section 4(e), discussed below, the BSE is concerned that such surcharges could be construed as a barrier to entry to BOX's flat and open marketplace.

*Proposed Chapter V, Section 17, Supplementary Material .03*—Concurrent with changes to certain sections regarding Information Barriers and Directed Orders (see discussion below of Chapter VI, Section 5(c)), the BSE has added a provision detailing the obligations of OFPs and Market Makers in regards to communications of information about orders being submitted to the PIP, or otherwise directed. The obligations are set forth as follows:

Prior to submitting an order to a PIP, an OFP cannot inform an Options Participant of any of the terms of the order, except as provided for in Chapter VI, Section 5(c) of these Rules. (See BSE Rules, Chapter II, "Dealings on the Exchange", Section 36, "Specialist Member Organizations Affiliated with an Approved Person").

The BSE is confident that these measures, along with other protections set forth elsewhere in the BOX Rules, will ensure that adequate measures are in place to protect against the use or misuse of any material, non-public information by any BOX Participant in regard to any order entrusted to him/her.

*Proposed Chapter V, Section 18(b)*—The Exchange is not changing or adding language to this section, but notes that this section is not intended to replace best execution principles. Rather, the BSE is supplementing best execution standards by the language set forth herein.

*Proposed Chapter V, Section 18(c)*—Similar to the above discussion, the BSE has added language in this section regarding orders for which matching business has been found. Previously, the provision limited Participants to only utilizing the PIP for these types of orders. To allow more flexibility to OFPs, the BSE has determined that OFPs can execute such orders on the BOX Book, but only after one of the following two prerequisites have been met "(i) agency orders are first exposed to the BOX book for at least thirty (30) seconds, or (ii) the OFP has been bidding or offering on BOX for at least thirty (30) seconds prior to receiving an

agency order that is executable against such bid or offer." These two alternatives are not applicable to Market Makers, rather they must abide by the requirements of Chapter VI, Section 5(b) and (c), regarding Directed Orders, discussed below. The first alternative in this section requires exposing the order on the BOX Book for a period of thirty seconds before attempting to execute against it. Under the second alternative, the OFP can execute the order immediately on the BOX Book if that OFP has been bidding or offering on the BOX Book for at least thirty seconds prior to receiving an agency order that is executable against such bid or offer. Additionally, the provisions state that an OFP must not otherwise deliberately attempt to effect a transaction, either under a single Participant or between two Participants, without following PIP procedures. With these provisions, the BSE is offering an OFP the flexibility of best-execution decision making, coupled with protections to ensure that Information Barriers are not breached, and that Participants are not acting in any way contrary to their customer's best interests.

*Proposed Chapter V, Section 18(e)*—In order to maximize the potential for price improvement of orders submitted to the PIP (which already, by definition, price improves all orders by at least one cent better than the NBBO), the BSE is requiring that in order for a PIP to commence there be at least three Market Makers quoting in a relevant series at the time a Participant submits a Primary Improvement Order to initiate a PIP. The BSE is confident that this requirement will be easily satisfied, given the accessibility to the BOX Market for Market Makers. Additionally, the BSE has clarified that a PIP will commence upon the dissemination of a broadcast message by BOX, which states "(1) that a Primary Improvement Order has been processed by BOX, (2) which contains information concerning series, size, price and side of market, and (3) states when a PIP will conclude."

*Proposed Chapter V, Section 18(g)*—The BSE has added a new paragraph to Chapter V, Section 18. This new paragraph provides that OFPs 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." CPOs shall include terms that state a price in standard increments (five or ten cents) at which the order will be placed on the BOX Book, as well as a price in pennies at which the Public Customer wishes to participate in any PIPs that may occur while his/her order is on the BOX Book. In order for a CPO to be eligible for

participation in a PIP, the CPO must be priced at or better than the NBBO. If a PIP commences in a relevant series and the CPO is at or better than the NBBO, then the OFF may, on behalf of the Public Customer, submit the CPO to the PIP for participation. Upon submission, the CPO will be treated similar to a Market Maker Improvement Order in the PIP; however, its terms cannot be cancelled or amended during the PIP.

The BSE believes that this provision will permit Public Customers greater control and flexibility in how their orders are handled on BOX. Public Customers will now be able to participate in PIPs. In addition, the BSE believes that offering to OFFs the prospect of this service on behalf of Public Customers will serve to increase the number of Participants competing in PIPs, ultimately leading to greater price improvement for orders on BOX.

The additions are as follows:

(a) "OFFs may provide access to the PIP on behalf of a customer that is not a broker-dealer ("Public Customer") in the form of a Customer PIP Order ("CPO") provided that:

i. The terms of each CPO shall include a price stated in rounded five cent or ten cent increments, as appropriate, ("standard tick") at which the order shall be placed in the BOX Book ("BOX Book Reference Price") as well as a specific price stated in one cent increments ("penny tick") at which the Public Customer wishes to participate in any PIPs ("CPO PIP Reference Price") that may occur while his order is on the BOX Book and displayed at the BOX Book Reference Price;

ii. The terms of each CPO shall include a specific order size ("CPO Total Size"). The number of contracts that may be entered into a PIP must be equal to the lesser of (a) the CPO Total Size remaining on the BOX Book or (b) the size of the Primary Improvement Order submitted to the PIP;

iii. In order for the CPO to be eligible for participation in a PIP in the subject options series, the BOX Book Reference Price for a CPO at the time a PIP commences must be equal to the NBBO.

iv. The CPO may only participate in a PIP on the same side of the market as the Primary Improvement Order.

v. Upon initiation of a PIP for which a CPO is eligible to participate pursuant to paragraphs (i)-(iv) above, the OFF who submitted the CPO to the BOX Book must submit a CPO to the PIP at the CPO PIP Reference Price.

vi. The terms of any CPO submitted to a PIP may not be amended or cancelled at any time during a PIP."

*Proposed Chapter V, Section 19(a)*—To clarify that a Market Maker Prime

cannot be both the Market Maker Prime and the party who initiated the process in the same PIP, thereby guarantying receipt of more than 40% of any allocation resulting from that PIP, the BSE has added a provision that "the Market Maker Prime must not have submitted the Primary Improvement Order to commence the relevant PIP."

*Proposed Chapter V, Section 27(b)(i)*—In order to remain consistent with similar rules regarding Complex Orders on other options exchanges, the BSE has added an exception which sets forth that Complex Orders with net price increments that are not multiples of the minimum increments are not entitled to trade ahead of other interest at the BOX best bid and offer.

*Proposed Chapter VI, Section 4 (e)*—The BSE deleted the provision, which imposed a monetary penalty on Market Makers who transacted business in classes outside of their appointments. Rather than a specific monetary penalty, which may have been construed as a barrier to entry to the BOX Market, the BSE has chosen to mirror provisions common on other options exchanges that permit Market Makers to trade outside of their appointments. This amendment also sets forth an execution percentage requirement that Market Makers must meet within the classes to which they are appointed. The additions are as follows:

Market Makers may transact business outside of their appointments, but the total number of contracts executed during a quarter by a Market Maker in options classes to which it is not appointed may not exceed twenty-five percent (25%) of the total number of contracts traded by such Market Maker.

*Proposed Chapter VI, Section 5(b) and (c); Section 10(g) and (h)*—To clarify the intention that Market Makers would be able to handle orders on an agency basis directed to them by OFFs, the BSE has changed "Customer Order" to "Directed Order" throughout Section 5, as well as in Section 10, which addresses Information Barriers. As previously discussed above, in the Definitions section of Chapter I, a Directed Order would be defined as an order directed to a Market Maker by an OFF. An OFF would send a Directed Order to BOX with a designation of the Market Maker to whom the order is to be directed. BOX would route the Directed Order to the appropriate Market Maker.

Proposed Sections 5(b) and (c) concern the requirements for a Market Maker who would handle a Directed Order. To address any concerns regarding informational barriers and the transfer of information, intended or not, which may accompany a Directed

Order, under proposed Section 5(c)(i) the BSE would prohibit a Market Maker from rejecting a Directed Order. Under proposed Section 5(c)(ii), a Market Maker has only two choices when he receives a Directed Order: (1) submit the order to the PIP process; or (2) send the order back to BOX for placement onto the BOX Book. If a Market Maker chooses to submit the Directed Order to the PIP process and he is currently quoting at a price equal to the NBBO, he must not adjust his quote prior to submitting such Directed Order to the PIP process.

Proposed Section 5(c)(iii) addresses the requirements when a Market Maker chooses not to enter the Directed Order into the PIP process, and therefore, must send the Directed Order to BOX for placement on the BOX Book. The following steps describe the Directed Order process from this point:

Step 1: Does the Market Maker who is sending the Directed Order to BOX have a quote on the opposite side of the Directed Order equal to the NBBO?

- If YES, then proceed to Step 4.
- If NO, then proceed to Step 2.

Step 2: The Market Maker would submit the Directed Order to BOX. The BOX trading engine would determine if the Directed Order were executable against the NBBO (the answer is "yes" in the case of a Directed Order that is also a BOX-Top Order).

• If NO, then BOX would place the Directed Order on the BOX Book to be treated as any other order.

• If YES, then BOX would proceed to Step 3.

Step 3: BOX would determine whether there are any quotes/orders on the BOX Book, which are equal to the NBBO.

• If NO, then BOX would submit the Directed Order to the trade-through filter process pursuant to proposed Chapter V, Section 16(b), described above.

• If YES, then BOX would execute the Directed Order against the quotes/orders on the BOX Book. If there is still any quantity remaining of the Directed Order, it would be filtered against trading through the NBBO according to the procedures set forth in Chapter V, Section 16(b) of these Rules and, if applicable, placed on the BOX Book.

Step 4: If a Market Maker's quote on the opposite side of the market from the Directed Order is equal to the NBBO, then the Market Maker would determine if the Directed Order is executable against the NBBO.

• If NO, then the Market Maker must send the Directed Order to BOX for placement on the BOX Book to be treated as any other order.

- If YES, then the Market Maker must guarantee execution of the Directed Order at the current NBBO for at least the size of his current quote. This guarantee would be defined as a Guaranteed Directed Order ("GDO").

Step 5: The Market Maker must then immediately send the Directed Order and the GDO to BOX.

Step 6: Upon receipt of the Directed Order and the GDO, BOX would execute the Directed Order against any quotes/orders already on the BOX Book, except the quote of the Market Maker who submitted the Directed Order and GDO.

Step 7: If there were any quantity remaining of the Directed Order, then BOX would send to all BOX Participants a Directed Order Broadcast ("DOB") message indicating the side (buy/sell), remaining size, and guaranteed price of the Directed Order.

Step 8: The Market Maker would be prohibited from executing for his proprietary account against the Directed Order for at least three seconds. During that time the Market Maker would not be allowed to decrement the size or worsen the price of his GDO. However, he would be able to increase the size of his GDO or improve its price (in standard five or ten cent increments only). During that period, any BOX Participant, except the Market Maker who submitted the Directed Order to BOX, may submit an order to the BOX Book in response to the DOB. Such a DOB response order would be treated as a BOX Limit Order. During that three-second period, any order submitted to the BOX Book that matches any order(s) on the BOX Book, except the Market Maker's GDO, would be executed.

If the Market Maker received a subsequent Directed Order during this period, pursuant to subparagraphs (c)(ii) and (iii), he would be able to either submit it to the PIP process or send it to the BOX Book, following the same process as for the first Directed Order. BOX would process any subsequent Directed Orders in sequence as they are submitted to BOX for either the PIP process or for placement on the BOX Book. Any remaining quantity of a Directed Order that may be placed on the BOX Book, such as at the end of either step 3 (above) or step 9 (below), is treated like other orders placed on the BOX Book. Therefore, the remaining quantity may execute against another Directed Order on the opposite side of the market, whether that second Directed Order is submitted to the PIP process or placed on the BOX Book.

Step 9: Three seconds after sending the DOB, BOX would release the remaining quantity of the Directed Order to the BOX Book. At that time,

BOX would immediately execute any orders on the BOX Book, including those submitted in response to the DOB, against the Directed Order on a price-time priority basis. However, the BOX trading engine would ensure that the GDO would yield priority to all such competing orders at the same price. If there is still any quantity remaining of the Directed Order, it would be filtered against trading through the NBBO according to the procedures set forth in Chapter V, Section 16(b) of these Rules and, if applicable, placed on the BOX Book.

The BSE believes that use of the DOB and the exposure of the Directed Order to the BOX market will serve to ensure that a Market Maker would not be able to act against the Directed Order using any privileged or other information regarding that order. In addition, the BSE has eliminated the exemption in Section 10(g) and amended Section 10(h) in order to clarify that Market Makers must comply with all provisions of the Section 10 when they receive and handle Directed Orders. In total, these amendments will ensure that Directed Orders are not disadvantaged or treated inconsistent with the BOX or BSE Rules.

The pertinent rule additions are as follows: Section 5—

(c) When acting as agent for a Directed Order, a Market Maker must comply with subparagraphs (i)–(iii) of this Paragraph (c).

i. A Market Maker that receives a Directed Order shall not, under any circumstances, reject the Directed Order.

ii. Upon receipt of a Directed Order a Market Maker must either:

(1) Submit the Directed Order to the PIP process, pursuant to Chapter V, Section 18 of these Rules. Under this option, if the Market Maker is currently quoting at a price on the opposite side of the Directed Order equal to the NBBO, he is prohibited from adjusting his quotation prior to submitting the Directed Order to the PIP process.

-or-

(2) Send the Directed Order to the BOX Book pursuant to subparagraph (c)(iii) below.

iii. When a Market Maker chooses not to enter the Directed Order into the PIP process, and therefore, must send the Directed Order to BOX for placement on the BOX Book, the following requirements shall apply:

(1) If the Market Maker's quotation on the opposite side of the market from the Directed Order is not equal to the NBBO, then the Market Maker must send the Directed Order to BOX.

a. The Trading Host will determine if the Directed Order is executable against the NBBO.

1. If the order is not executable against the NBBO, then the Trading Host will enter the Directed Order onto the BOX Book for processing consistent with all non-executable orders.

2. If the Directed Order is executable against the NBBO, then the Trading Host will determine if there are any orders on the BOX Book equal to the NBBO.

i. If there are no orders on the BOX Book equal to the NBBO, then the Trading Host will filter the Directed Order against trading through the NBBO according to the procedures set forth in Chapter V, Section 16(b) of these Rules.

ii. If there are orders on the BOX Book equal to the NBBO, then the Trading Host will execute the Directed Order against those orders. Any remaining quantity will be filtered against trading through the NBBO according to the procedures set forth in Chapter V, Section 16(b) of these Rules and, if applicable, placed on the BOX Book.

(2) If the Market Maker's quotation on the opposite side of the market from the Directed Order is equal to the NBBO, then the Market Maker will determine if the Directed Order is executable against the NBBO.

a. If the order is not executable against the NBBO, then the Market Maker must send the Directed Order to BOX for placement on the BOX Book for processing consistent with all non-executable orders.

b. If the order is executable against the NBBO, then the Market Maker shall guarantee execution of the Directed Order at the current NBBO for at least the size of his quote. This guarantee shall be called a Guaranteed Directed Order ("GDO"). The Market Maker must immediately send the Directed Order with the GDO to the Trading Host.

1. The Market Maker who submitted the Directed Order and the GDO to the Trading Host:

i. Shall not submit to the BOX Book a contra order to the Directed Order for his proprietary account until the Directed Order is released to the BOX Book pursuant to subparagraph (c)(iii)(2)(b)(4) below.

ii. Shall not decrement the size or worsen the price of his GDO.

iii. May increase the size of his GDO.

iv. May improve the price of his GDO (only in five or ten cent minimum trading increments, as applicable pursuant to Chapter V, Section 6 of these Rules).

v. Upon receipt of a subsequent Directed Order, may either submit it to the PIP process or send it to the BOX

Book pursuant to subparagraphs (c)(ii) and (iii).

2. Upon receipt of the Directed Order, the Trading Host will execute the Directed Order against any matching orders on the BOX Book, except the order of the Market Maker who submitted the Directed Order.

3. If there is any quantity remaining of the Directed Order, then BOX will send to all BOX Participants a Directed Order Broadcast ("DOB") message indicating the side (buy/sell), remaining size, and guaranteed price of the Directed Order. For the following three seconds, any BOX Participant, except the Market Maker who submitted the Directed Order, may submit an order to the BOX Book in response to the DOB. Such a DOB response order will be treated as a BOX Limit Order.

4. During the three-second period following the DOB, any order submitted to the BOX Book that matches an order already on the BOX Book will be executed. Three seconds after the DOB, the Trading Host will release the remaining quantity of the Directed Order to the BOX Book. At that time, the Trading Host will immediately execute any orders on the BOX Book against the Directed Order on a price-time priority basis. The GDO shall yield priority to all such competing orders at the same price. Any remaining quantity of the Directed Order will be filtered against trading through the NBBO according to the procedures set forth in Chapter V, Section 16(b) of these Rules and, if applicable, placed on the BOX Book.

*Proposed Chapter VI, Section 6(b) and (f)*—BOX Market Makers undertake a meaningful obligation to provide continuous two-sided markets. These obligations include the requirement that quotations be for a size of at least ten contracts, and within the legal width of the market. Under the amendments to the proposed rules, a Market Maker must respond to a Request for Quote ("RFQ") message within fifteen seconds, with a similarly valid quotation. The Exchange believes that this fifteen-second period is ample time for a Market Maker to respond in an automated market, particularly given other BOX features, such as the PIP, which require a much shorter response time. Nevertheless, realizing that an RFQ may require a Market Maker to furnish a quote where he might not otherwise choose to, the BSE is proposing that fifteen seconds is a sufficient amount of time in which to enable a Market Maker to generate a meaningful quotation response. Although the BSE is confident that it has provided a marketplace, which will be robust and liquid, the delineated

responsibilities added to this section will serve to guarantee that Market Makers provide liquidity to the market, and do so on a continuous basis.

The added language to Section 6(b) is set forth as follows:

ii. If a Market Maker is not already posting a valid (*i.e.* for ten contracts, within the legal width of the market, as applicable) two-sided quote in a series in a class in which he is appointed as Market Maker, he must post a valid two-sided quote within fifteen (15) seconds of receiving any RFQ message issued. The valid two-sided quote so posted must be retained by the Market Maker for at least thirty (30) seconds.

iii. Every RFQ message issued, and every responsive quote, must be for a minimum size of at least ten contracts, and must be within the legal width of the market, as applicable.

In paragraph (f) the BSE has changed the time period to six months for which the Board would have exemptive authority to grant Market Makers exemptions from the requirements of paragraph (e)(iii) of this Section 6.

*Proposed Chapter VIII, Section 7*—The BSE has added anti-money laundering provisions similar to the rules in place on other exchanges.

*Proposed Chapter XI*—To clarify that OFPs, as opposed to Options Participants generally, are the only types of Participants that can deal directly with the public, the BSE has changed the references to "Options Participants" to "OFPs" throughout Chapter XI, "Doing Business with the Public."

*Proposed Chapter XII*—As with all options exchanges, the BSE is adding Intermarket Linkage Rules to the BOX Rules. These rules are substantially similar to the rules in place on all of the options exchanges. Several Comment Letters expressed concern regarding BOX's participation in the Intermarket Linkage Plan. Subject to Commission approval, BOX, through the BSE, would become a full participant in the Intermarket Linkage Plan ("Linkage" or "Plan") for the options markets. As such, BSE would comply with the obligations of the Plan and has added Intermarket Linkage Rules to the BOX Rules. The following is an overview of how the BOX Market would interact in the Plan and is not intended to be a comprehensive discussion of how the proposed Intermarket Linkage Rules of Chapter XII of the BOX Rules<sup>12</sup> apply to Options Participants:

*Principal ("P") Orders Sent From BOX to Away Markets.* A BOX Eligible

Market Maker ("BEMM")<sup>13</sup> may submit a P order to the BOX trading engine for routing to one or more away markets provided the following conditions are satisfied:

- The BEMM is a BOX Market Maker on the class for which the P order is submitted.

- The BEMM has complied with the Plan's "80/20 rule" for the previous calendar quarter.

- Prior to sending the P order, the BEMM is posting a bid and an offer for at least ten contracts within the allowable price spread for the class.

Provided the above conditions are met, the BOX trading engine would automatically route the BEMM's P order to the designated exchange and transmit back any responses (*e.g.*, order executions, rejections) that BOX receives from the away market via OCC.

*P Orders Sent From Away Markets to BOX.* Orders sent to BOX by Eligible Market Makers (as set forth in the Plan) from away exchanges via the Linkage are processed as though they were orders received directly from a BOX Participant. That is, these orders would execute automatically on the BOX trading engine against any orders on the BOX Book up to either the quantity on the BOX Book at that price or the actual quantity of the P order, whichever is less, but in no event for less than ten contracts. BOX would automatically attempt to fill any remaining quantity by exposing the unexecuted portion at the NBBO for three seconds to all BOX Participants.

*Principal-as-Agent ("PA") Orders Sent From BOX to Away Markets.* To ensure that there is an Eligible Market Maker per Eligible Class (as those terms are defined in the Plan) for the submission of PA and Satisfaction orders to away markets, BOX would specifically designate a BEMM in each Eligible Class traded on BOX responsible for such orders. The BEMM would adhere to the responsibilities of an Eligible Market Maker as set forth in the Plan.

Only orders submitted by BOX Participants on behalf of Public Customer accounts may generate a PA order. Each Public Customer order is checked against the NBBO using BOX's trade-through filter mechanism as set forth in chapter V, section 16(b) (described above). If BOX is not matching the away best price, the order is exposed to BOX Participants for three seconds at the NBBO price.

At the end of this three-second period, if the order is not fully executed

<sup>12</sup> See Proposed BOX Rules, Chapter XII (Intermarket Linkage Rules).

<sup>13</sup> A BOX Market Maker who meets the requirements of an Eligible Market Maker as set forth in the Plan.

and a better price exists at an away exchange(s), a PA order is generated automatically by the BOX and routed to the away exchange with the required BEMM, clearing and valid-clearing-firm ("VCF") information included. Each execution received from an away exchange results in the automatic generation of a trade execution on BOX between the original Public Customer Order and the BEMM.

*PA Orders Sent From Away Markets to BOX.* In the case when BOX receives PA orders from away markets, but BOX is no longer quoting at the NBBO, then such PA orders are filtered against trade-throughs in the same manner as Public Customer orders submitted by BOX Participants as set forth in Chapter V, section 16(b), described above. If their execution would cause a trade-through, the PA orders are exposed to BOX Participants for three seconds at the NBBO price. If PA orders are not fully executed at the end of this period, the residual quantity is canceled back to the originating away exchange. In this manner, PA orders are afforded the same opportunity for execution as Box Public Customer orders.

*Satisfaction ("S") Orders Sent From BOX to Away Markets.* Each BOX Participant may request, on behalf of a Public Customer, that BOX route an S order to an away market for orders on BOX that were traded through by the away market. BOX would systemically verify the validity of the request (e.g., as to Public Customer status, time stamp of order prior to report of trade-through), and, if valid, generate an S order with the required BEMM, clearing and VCF information included. As execution confirmation is received from the away market, the BOX trading engine would automatically generate offsetting trades between the original BOX Public Customer order and the BEMM.

*Satisfaction Orders Sent From Away Markets to BOX.* S orders received from away markets are systemically verified (e.g., as to Public Customer status, time of trade-through on BOX). Once verified, the BOX Participant that caused the trade-through is identified and, within three minutes, the S order is executed against that BOX Participant. Where there were multiple S orders, the executions are made pro rata with the total not to exceed the lesser of the trade, which caused the trade-through or the total quantity of the S orders.

*Proposed Chapter XIII*—The BSE is adding a new Chapter, entitled "Margin Requirements," to its proposed BOX Rules. Similar to the approach of at least

one other options exchange,<sup>14</sup> the BSE proposes to require that BOX Participants and associated persons, among other things, adhere to the requirements of either the New York Stock Exchange ("NYSE") or the Chicago Board Options Exchange ("CBOE"), as those rules may be in existence from time to time. Additionally, in order to ensure that the BOX Rules adequately address situations involving Joint Back Office ("JBO") arrangements for Participants who are not an NYSE member and have elected to be bound by CBOE margin requirements, the BSE has included in the BOX margin requirements a set of rules specifically addressing JBO arrangements. In this way, the Exchange is ensuring that its margin rules cross-reference other exchanges' rules as appropriate, and, where not sufficient, adequately provide for the necessary requirements.

## 2. Statutory Basis

The Exchange believes that the proposed rule change, as amended, is consistent with the requirements under Section 6(b) of the Act,<sup>15</sup> in general, and furthers the objective of Section 6(b)(5) of the Act,<sup>16</sup> in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transaction in securities, to remove impediments to and perfect the mechanism for a free and open market and a national market system, and, in general, to protect investors and the public interest.

### B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change, as amended, will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

### C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The Exchange did not solicit or receive written comments on the proposed rule change, as amended.

## III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding, or (ii) as to which the Exchange consents, the Commission will:

(A) by order approve such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

## IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 3, including whether Amendment No. 3 is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filings will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to File No. SR-BSE-2002-15 and should be submitted by September 12, 2003.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>17</sup>

**Margaret H. McFarland,**  
Deputy Secretary.

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<sup>14</sup> See e.g., ISE Rule 1202.

<sup>15</sup> 15 U.S.C. 78f(b).

<sup>16</sup> 15 U.S.C. 78f(b)(5).

<sup>17</sup> 17 CFR 200.30-3(a)(12).