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

Re: Proposed Rule Change by the Boston Stock Exchange, Inc. Establishing Trading Rules for the Boston Options Exchange Facility, File No. SR-BSE-2002-15

Dear Mr. Katz:

The Interactive Brokers Group, on behalf of its affiliates Timber Hill LLC and Interactive Brokers LLC, respectfully submits these comments on the proposed rules of the Boston Stock Exchange ("BSE") for trading on its new options trading facility ("BOX"). The Interactive Brokers Group ("IB Group") is keenly interested in issues relating to the nation's options markets and is a minority investor in the Boston Options Exchange Group LLC. Timber Hill LLC is a specialist and market maker on all existing U.S. options exchanges and Interactive Brokers LLC offers brokerage services to public customers who trade options. The mission of all of the IB Group companies is to deploy advanced technology and automation in order to reduce the total cost of trading borne by the public. As set forth below, we believe that the creation of a new, all-electronic options market based on the rules proposed by the BSE will substantially improve transparency and competition in the options industry and will lead to fairer, more liquid and lower cost options trading for the investing public. We urge the Commission to approve the BOX rules.

I. Electronic Markets Provide Greater Transparency and Protection for Customers

The most important advantage that will be offered by the BOX market is that the order handling and execution process will be completely automated. The trading rules, practices and policies for the market will be clear and objective and will be embodied in computer code, and each step in the order handling process will be evidenced in a comprehensive electronic audit trail, reducing the opportunity for mishandling or abuse of customer orders and ultimately leading to lower realized trading costs for the public.

In the comment letters on the BOX rule filing, there will likely be much discussion as to how the BOX market trading rules compare to the trading rules for the existing floor-based exchanges. This is a worthwhile topic but the analysis is made difficult by the fact that the rules of floor-based exchanges often bear little relationship to what actually happens on the floor. The "custom and practice" of the floor is often at odds with the written rules or not even addressed in the written rules, as the Commission has observed in recent years.

Firm quote practices are a prime example of this. On the floor-based exchanges, market makers and specialists have an inherent time and place advantage because they can see orders before others can see them and can often take their time to decide whether to interact with these orders or not. Any investor that frequently trades options knows that specialists can and do fade their quotes after receiving an order, and that the likelihood of an execution goes up as the market moves against the customer. Automatic execution ("auto-ex") has helped the situation somewhat but there are many exceptions to automatic execution built into the rules. In addition, on some exchanges specialists simply disable auto-ex systems seemingly at will, regardless of whether there is a valid reason. Once orders are kicked out of auto-ex systems and on to the floor, they are subject to faded quotes, delays in execution, or disparate treatment based on the originating order entry firm (if that firm's order flow is perceived to be "smart").

None of this can happen in the BOX market. There is no way to fade a quote. All marketable orders will be executed automatically and instantaneously, and there are no auto-ex "kick-out" rules or exceptions or other fail-safes designed to protect professionals at the expense of customers. In short, the oversight roles of the BSE and the Commission with respect to the BOX market will be made simpler because many questionable trading practices are simply impossible on BOX and those that are still possible will be easier to detect because of a complete, time-sequenced electronic audit trail. Moreover, the BOX rules are clear and objective and will be hard-coded into the BOX trading engine.

II. The Open Structure of the BOX Market Will Enhance Liquidity and Facilitate Competition

All of the existing U.S. options exchanges share the same general market structure (including the ISE to a somewhat lesser extent):

- a limited number of exclusive specialist franchises allocated by largely subjective processes;

- disincentives and practical impediments for market makers in the crowd to post more competitive prices than the designated specialist who controls the quote;

- high trading and membership costs (in the millions of dollars to get a decent range of specialist appointments), which must be recouped from public customers;

- high order cancellation fees (far in excess of processing costs) that penalize customers for changing their order prices when the market is moving against them, as well as manual cancellation processes that may "slow down" when a customer is trying to cancel an order that is going against him;

- trading rules that limit access to the market and obstruct certain orders from interacting with each other, including:

  - differential firm quotes for broker-dealers and public customers;
  - exclusion of broker-dealer or away market maker orders from automatic execution in some classes;
  - vague and discretionary auto-ex kick-out and shut-off rules;
  - vague and discretionary erroneous trade policies;
  - one-sided restrictions on the trading methods that may be used by public customers (*e.g.,* 15 second "speed bump rules", rules requiring customers to manually transmit all orders, and open-ended rules prohibiting customers from "regular and continuous" trading).

The BOX market model eliminates all of these roadblocks. There are no seats for market makers and other members to buy or lease, and market makers will pay only modest fees based on their level of activity. There will be no franchise allocation process and no specialists who control the book and can directly or indirectly prevent market makers in the crowd (or non-member broker-dealers and customers) from posting better prices. All market makers in a class on BOX will be anonymous to each other and will have equal access instantly to place quotes on the book. All orders on the book (from public customers, non-member broker-dealers and BOX market makers) will interact on an equal footing in strict price/time priority. Customers may immediately revise or cancel orders in response to market movements, for no fee.

In addition, there is no prohibition against sophisticated public customers seeking to provide liquidity to the market by placing two-sided limit orders on BOX (even on a regular and continuous basis). There is no prohibition against public customers using computers to generate option values or to generate and transmit orders. There is no speed bump rule requiring customers to wait a certain number of seconds after sending an order before they send another order. The BOX market eliminates the thicket of restrictive trading rules that has grown up in the markets over recent years.

III. The Price Improvement Auction on BOX Will Help Solve Market Structure Problems Created by Payment for Order Flow and Internalization

The Commission has been rightly concerned about internalization and payment for order flow practices in the options market. Small order flow is inherently valuable and it is made even more so because of the lack of granularity in the nickel tick increment for options trading. There are by definition only three parties in each option transaction that may capture this inherent value: 1) the specialist and the market makers in the crowd who ride along; 2) the order flow provider; and 3) the customer. On every existing options exchange the customer is affirmatively precluded from capturing any of this value because automatic execution systems simply print trades ***at*** the best bid or offer with ***no*** auction or other mechanism for price improvement and very little price competition in the establishment of the NBBO itself (the nickel increment combined with the specialists' ability to step up and match other exchanges at the NBBO greatly reduces the incentive to improve the spread).

Since the customer receiving an automatic execution on any of the existing exchanges cannot recover any of the bid-ask spread that will be earned on the trade, the argument about "payment for order flow" and "internalization" is basically an argument between order flow firms and market making firms over who will capture this value. Even if it could be outlawed, elimination of payment for order flow under the current structure will simply mean that the market makers would keep all of the spread generated from automatic executions at the NBBO. By contrast, if payment for order flow continues, some of the spread will continue to be paid back to the order flow firms. In neither case will the customer recapture anything.

In order to offer a better and more open alternative to the NBBO auto-ex facilities of the existing exchanges, the BOX rules provide for a Price Improvement auction process that allows BOX Order Flow Providers and Market Makers to seek to interact with their own order flow to a certain level, but also demands price improvement over the NBBO and a truly competitive electronic auction prior to the trade.

The BOX Price Improvement auction offers many advantages over the automatic execution systems on existing exchanges[1]:

- The auction will start at least one penny better than the NBBO, which means that customers -- even before the auction commences -- will recapture at least 10-20% of the bid-ask spread in the most commonly traded options series.

- Because there is an actual electronic auction (rather than simply an auto-ex print) and because the tick increment is in pennies, the customer will be allowed to get the benefit of the true best price for the option. There is no artificial spread built into the system.

- In contrast to auto-ex “wheels” where market makers passively receive a pre-set allocation, market makers on BOX will be rewarded in proportion to the competitiveness of the prices they bid and offer during Price Improvement auctions.

- In addition, a BOX market maker who is the first to have bid or offered at the NBBO *before* an auction starts (the “Market Maker Prime”) will be rewarded with a higher allocation if that market maker is among the winners of the auction. This creates a systematic incentive for BOX market makers to improve the NBBO at all times.

- The Price Improvement auction process should also increase participation and liquidity in the BOX market because any Order Flow Provider or Market Maker can initiate a Price Improvement auction – it is not limited to a single specialist who has bought the right to auto-ex trades at (but not better than) NBBO.

[1] The BOX Price Improvement auction also offers many advantages over the facilitation/crossing rules of the existing exchanges. BOX Price Improvement Orders are firm and cannot be cancelled during the Price Improvement auction. Thus, from the outset of the auction a customer is guaranteed a locked-in trade at a price at least a penny better than the NBBO, and the Order Flow Provider (and not the customer) bears full risk that the market may move against it (this is why the auction period is limited to three seconds). On other exchanges, facilitation/crossing orders may be cancelled at any time during the exposure period and thus may be executed at a price worse for the customer than the market price when the order was placed, or not executed at all. In addition, under the BOX market trading rules, no one would get a “last look” to step up and match the prices bid or offered during the Price Improvement auction. Therefore the BOX member that is attempting to trade with its own order through the Price Improvement process, as well as the Market Makers who are competing to break up the order, all have a strong incentive to put their best prices forward ***before*** the Price Improvement auction ends. By contrast, the crossing practices on rules of other exchanges contemplate that either the facilitating firm or the crowd gets a last look.

In sum, the BOX Price Improvement auction seems to be the best chance on the horizon to return to customers some of the spread that they now pay under the current system of automatic execution at the NBBO. This type of structural solution seems more likely to make a difference for the customer than the somewhat disingenuous arguments between order flow firms and specialists/floor traders over whether the latter will have to pay the former for orders.

One commenter has criticized the Price Improvement auction process because only BOX market makers (and not public customers) may compete during the auction process.[2] This precludes sophisticated semi-professional liquidity providers who trade as public customers from trading against customer orders that are executed through the Price Improvement auction. First, it is worth noting that on every other U.S. option exchange it is *unlawful* for a public customer to act as a professional liquidity provider and to "regularly and continuously" provide quotes. These semi-professional traders certainly have no opportunity to participate on the auto-ex wheel or in the facilitation/crossing processes on today's exchanges. Indeed, the exchanges routinely harass brokerage firms that handle these semi-professional accounts and are constantly conducting inquiries to prevent public customers from acting like market makers. Thus, semi-professional traders will do no worse on BOX than on the other exchanges and in most respects will fare much better (see above).

In addition, the ability to participate in Price Improvement auctions is one of the few incentives to becoming a BOX market maker. Although the BOX market is based on an open order book model, it is necessary to have the category of "market maker" to respond to concerns that there might be insufficient liquidity in the market if it were a pure open order book with no affirmative market making obligations for any member firms. In addition, certain aspects of the intermarket linkage plan require the presence of a designated class of exchange market makers. Except for the ability to use the bulk quote update function of the NSC system, there are no real advantages to being a BOX market maker -- particularly compared to the myriad of advantages enjoyed by market makers and primary market makers on other exchanges.

The fact that only market makers (and the initiating order flow provider) may participate in Price Improvement auctions also should not be of concern because there are very few barriers to becoming a BOX market maker. Market makers are not required to buy or lease memberships; transaction and registration fees for market makers will be very low; and there is no limit on the number of firms that can act as market maker in a given class except to the extent of any temporary technological constraint while excess capacity is added if needed. Disallowing semi-professional traders that are not willing to accept any market making responsibilities from participating in Price Improvement auctions is a reasonable way to provide some incentive for traders and firms to assume the role of Market Maker, thus creating liquidity and stability on the Exchange without

[2] See Comments of Mike Ianni (Feb. 3, 2003),

sacrificing the interests of customer protection. The Commission has approved this type of incentive time and again in the options and equities markets and has not had great sympathy for professional traders who wish to act as market makers without wanting to assume the attendant responsibilities.

IV. Conclusion

The Exchange Act does not require that all markets share the same structure. Indeed, allowing a new and different market model to be established will be healthier for the nation's options markets than a continuance of the status quo in which all the exchanges are based on the same general specialist franchise model. As required by Section 6(b)(5) of the Exchange Act, the rules of the BOX market will "promote just and equitable principles of free trade, … remove impediments to and perfect the mechanism of a free and open market and a national market system" and "will not permit unfair discrimination between customers, issuers, brokers or dealers." We respectfully ask that the Commission approve the BOX trading rules as quickly as practicable.

We thank the Commission and its staff for their time and consideration of our comments. Please contact either of undersigned if you require any additional information or would like to discuss these matters further.

s/ Thomas Peterffy

Thomas Peterffy
Chairman

s/ David M. Battan

David M. Battan
Vice President and General Counsel
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