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Elizabeth Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: File No. S7-08-09; Short Sale Regulation

Dear Ms. Murphy:

The International Securities Exchange, LLC ("ISE") appreciates the opportunity to comment on the above-referenced proposal by the Commission regarding the regulation of short sales.[1] The Commission asks whether, in light of the recent market turmoil, the Commission should reinstitute the short sale "uptick rule" or another form of enhanced short sale regulation. Assuming it concludes that some form of increased regulation of short sales is appropriate, the Commission offers various alternative short sale restrictions. The two major approaches are: a full-time price test for all securities; or a "circuit breaker" that would apply only to a specific security during a severe price decline in that security. In the latter case, the "circuit breaker" could trigger either a prohibition on short sales or a price test for a set period of time.

The ISE believes it would not be appropriate to adopt any additional regulation to limit short sales at this time. The Commission has studied this area in depth and now has in place the most appropriate form of short sale regulation. However, if the Commission ultimately determines to impose additional short sale regulation, we believe that any such regulation should be as narrowly focused as possible. We would recommend a circuit breaker-triggered, bid-based price test. Finally, we believe that any such regulation must contain an exemption for options market makers.

There is No Need to Reinstitute Additional Short Sale Regulation

There is no dispute that short selling serves a critically-important function in our securities markets. The Commission describes these benefits in detail in the Release,

[1] Release No. 34-59748 (April 10, 2009); 74 F.R. 18042 (April 20, 2009) (the "Release").

explaining how short selling provides liquidity and pricing efficiency.[2] At the same time, the Commission notes that short selling can be used for manipulative purposes, such as "bear raids" that drive down the price of a security.[3] While that is the case, almost any legitimate trading strategy can be misused for manipulative purposes. Indeed, market participants can use buying programs to manipulate the price of a security upwards to inflate the value of portfolios or otherwise to gain economic advantage. We believe that the Commission's regulatory focus should not be on any particular trading strategy, but on addressing potential fraud and market abuse in a manner that does not unnecessarily restrict trading – regardless of the type of trading involved.

Over the past few years, the Commission has followed exactly this approach with respect to short sales by removing unnecessary restrictions and focusing its regulatory efforts to combat fraud. Most importantly, the Commission carefully evaluated the effectiveness of the old "tick test" in Rule 10a-1 and eventually eliminated that rule.[4] The Commission then adopted a rule directed at "naked" short selling.[5] The Commission further imposed enhanced delivery requirements for all equity securities on an emergency basis.[6] The Commission also enhanced the disclosure rules regarding short sales by issuing an interim rule requiring disclosure of short sales and short positions in certain securities.[7] These actions have given, and continue to give, the Commission critical information regarding short sale activity.

We believe that this new regulatory structure addresses the potentially abusive aspects of short selling by focusing on "naked" short sales and failures to deliver. It further provides the Commission with what we believe is all the necessary information regarding short sales so that it can properly monitor short selling activity, and can use that information to determine whether further regulation is necessary in the future.

We have reviewed comment letters the Commission has received to date on the Release, as well as the Commission's short sale "roundtable" on May 5th. We have not seen any comments that provide the analysis and data that the Commission requested to support any potential new short sale regulation. Commentators simply have stated unsupported conclusions about the need for regulation or have focused on what they believe to have been flaws in the Commission's previous analysis in repealing the uptick

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[2] Release at 18044.

[3] Id.

[4] Release No. 34-50104 (July 28, 2004), 69 F.R. 48032 (August 6, 2004).

[5] Release No. 34-58774 (October 14, 2008), 73 F.R. 61666 (October 17, 2008).

[6] Release No. 34-58572 (September 17, 2008), 73 F.R. 54875 (September 23, 2008). The Commission then adopted a slightly amended version of that rule, Rule 204T. Release No. 34-58773 (October 14, 2008), 73 F.R. 61706 (October 17, 2008). Rule 204T generally requires the delivery of securities on settlement date or the close-out of any fail to deliver position by the next settlement date. Rule 204T will remain in effect until July 31, 2009 unless the Commission takes further action before then.

[7] Release No. 34-58785 (Oct. 15, 2008), 73 F.R. 61678 (Oct. 17, 2008). The interim rule expires on August 1, 2009 unless the Commission takes further action before then.

rule. None of those comments provide a valid reason to reinstitute such a level of market-intrusive regulation. We believe that the Commission should continue to focus its short sale regulatory efforts on addressing manipulation and enhancing disclosure rather than imposing unnecessary prophylactic market-wide trading restrictions.

<u>If the Commission Reinstitutes a Test it Should Adopt a Circuit Breaker Bid Price Test</u>

We appreciate that the Commission is under significant political pressure with regard to short sales. However, as discussed above, there is no record to support instituting any of the extensive proposed short sale limits discussed in the Release. But if the Commission determines that it must take action in the area, our recommendation would be to take action that would inflict the least harm on the markets, and that would not undermine the major benefits of short sales the Commission itself identified: providing liquidity and enhancing price discovery.

The Commission requests comment on two different approaches to short sale regulation: a full-time market-wide price test; and restrictions that would apply only as "circuit breakers" to an individual security if that security hits some pre-determined decline in price. There are numerous variations to these two approaches. For example, with respect to the circuit breaker approach, the Commission seeks comment on what would happen if a price decline in a security would trigger the circuit breaker, such as a temporary prohibition on short sales or the imposition of price test. The Commission further seeks comment on two possible price tests, based either on the last sale of a security ("uptick rule") or a bid-based price test ("modified uptick rule").

Unless proponents of short sale regulation present convincing data supporting a market-wide price test – and no such data have been presented to date – we see no basis for re-imposing any form of the old uptick rule on a market-wide basis. Not only is there no proven benefit of a market-wide uptick rule, such "full-time" regulation would have the most egregious effect on pricing efficiency and liquidity by imposing limits on trading activity throughout the entire day regardless of market conditions. Limiting short sale regulation to cases of severe market declines would minimize the adverse effect of the restrictions.

In discussing circuit breakers, the Commission states that it preliminarily favors a trigger of a 10 percent decrease in the price of a stock. We believe that this is too narrow of a trigger and recommend a trigger of at least 20 percent. The Commission cites as support for a 10 percent trigger the current self-regulatory organizations' general circuit breaker rules, in which a decline in certain broad-based market indices of that amount lead to market-wide trading halts of specified lengths. We do not believe that it is appropriate to base individual stock circuit breakers on the historic use of broad-based index circuit breakers.

Individual stocks can be very volatile for a variety of reasons, including company-based, industry-based, and marked-based factors. In contrast, broad-based indices tend to neutralize company- and industry-based factors. Thus, it is much more likely for individual stocks to move by 10 percent in any given day than it is for indices, triggering many more applications of the short sale restrictions than would be appropriate. Increasing the threshold to a higher level, such as 20 percent, would help ensure that the short sale restrictions come into effect only in truly extraordinary situations.

Whatever the ultimate threshold, we agree with the Commission's preliminary belief that any resulting short sale trading restrictions should be based on the bid price, not last sales.[8] That is, persons would be prohibited from effecting short sales except when the most recently-reported bid price was higher than the previously-reported different bid price. As the Commission notes, bids generally are a more accurate reflection of current prices for a security because they are better sequenced across market places and must be firm for their stated size. In contrast, market centers can report last sales any time within 90 seconds of an execution, and thus may not reflect the exact sequencing of trades. Adopting short sale restrictions based on what may be an inaccurate sequencing of trade reporting only would exacerbate the inherent problems with short sale restrictions.[9]

Any New Short Sale Regulation Should Exempt Options Market Makers

If the Commission adopts any of the contemplated additional restrictions on short sales, we believe it is imperative for the Commission to exempt options market makers from any such restrictions. The Commission exempted options market makers from its 2008 order temporarily banning short sales in certain stocks.[10] In so doing, the Commission specifically noted the importance of options market makers in providing liquidity. The Commission now proposes to exempt options market makers from any circuit breaker "halt rule" that would prohibit short sales when the price of a security declines a set amount. We support that exemption, but note that the Commission is not proposing an options market maker exemption from any of the proposed "tick tests," whether the full-time test or the test triggered by circuit breakers.

If the Commission does adopt a tick test, we strongly urge the Commission to exempt options market makers from that restriction. The exemption should apply whenever an options market maker effects a short sale to hedge its exposure relating to bona fide market making activity. Failure to exempt options market makers from these

[8] See Release at Section III.a.1.

[9] We do not mean to imply that basing short sale restrictions on bid pricing is without problems. In fast moving markets, and with penny quoting, there could be significant quotation flickering, making it fairly arbitrary as to when persons could and could not effect short sales.

[10] Release No. 34-58592 (September 18, 2008), 73 F.R. 55169 (September 24, 2008).

short sale restrictions would have far-reaching negative implications that would more than outweigh any speculative benefits of the short sale restrictions.

Options market makers play a unique role in providing liquidity to the market. While trading in an equity security is concentrated in one product, the trading in options on that security could be spread over 100 or more series of options contracts. Thus, equity exchanges trade less than 10,000 stocks in the United States while, on the ISE alone, we list and trade almost 275,000 option series. Each of these products is an individual security and the ISE, as is the case on most exchanges, requires options market makers to provide continuous quotations in these instruments. With such dispersed liquidity there is very little natural customer interaction in options, requiring options market makers to provide customers with the liquidity necessary to support continuous trading.

On the ISE we estimate that approximately 98 percent of the quoted size in our market represents quotations of options market makers. For market makers to provide customers with this level of liquidity they need efficient access to the market for the underlying stock in order to hedge their options positions. Specifically, when an options market maker takes a position in filling a customer order by buying calls or selling puts, the market maker has exposure to that position that can only be hedged by selling the underlying stock short. Requiring options market makers to await an uptick before they can hedge their positions would seriously impede their ability to quote tight and liquid markets. That would lead to a serious erosion in the quality of virtually all the quoted size in our market.

We further note the emphasis that the Commission places on enhancing investor confidence during market turbulence. We certainly agree with that goal, and further believe that limiting liquidity and inhibiting pricing efficiency will do more to undermine investor confidence in the market than any speculative benefits achieved by reducing the pricing effects of short sales by options market makers hedging their market making positions. Investors who buy or sell options have a reasonable expectation that they will be able to unwind their positions at competitive and attractive prices. However, the imposition of a tick test at a time of market stress will seriously undermine the ability of investors to close-out their positions, impeding the operation of the market and investor confidence during these critical time periods.

As discussed above, we believe that the focus of the Commission's short sale regulation should be the prevention of fraud. By definition, when options market makers engage in legitimate hedging activity they are not – and cannot – be engaging in fraudulent activity. This is legitimate trading activity intended to provide liquid and efficient markets for investors. The ISE and the other options exchanges have vigorous regulatory programs in this area to ensure that market makers will not abuse this exemption.

There is strong precedent for exempting options market makers from a bid-based tick test. Specifically, the only bid-based short sale restriction was NASD's bid test for the Nasdaq market before Nasdaq achieved exchange status. The NASD had adopted a bid test rather than a price test due to the dispersed nature of the Nasdaq dealer market and the inherent problems in sequencing trade reports from disparate market makers. As with the current Commission proposal, the main reason behind the NASD's short sale rule itself was to enhance investor confidence in the Nasdaq market. We are not aware of concerns that the Nasdaq bid test was any less successful in promoting investor confidence because there was an options market maker exemption. We thus urge the Commission to follow this precedent and include an options market maker exemption in any price test it may adopt.

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The ISE again thanks the Commission for the opportunity to comment on this most important issue. We urge the Commission to act cautiously and not impose unnecessary regulations on the investment community. Unnecessary short sale restrictions will harm pricing efficiency and reduce liquidity. This is the exact opposite of what the Commission should seek to achieve in times of market stress. We understand the pressure on the Commission to "do something." If the Commission therefore determines that it must take action, we suggest the Commission adopt a bid-based circuit breaker tick test, while exempting options market makers from that test.

If you have any questions on our comments, or if we can be of further assistance to the Commission, please do not hesitate to contact us.

Sincerely,

Michael J. Simon
Secretary