

**Boston Options Exchange  
Chicago Board Options Exchange  
International Securities Exchange  
NASDAQ Options Market  
NASDAQ OMX PHLX  
NYSE Amex  
NYSE Arca  
The Options Clearing Corporation**

June 22, 2009

Ms. Elizabeth Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549-1090

**Re: File No. S7-08-09**

Dear Ms. Murphy:

The Boston Options Exchange, the Chicago Board Options Exchange, the International Securities Exchange, NASDAQ Options Market, NASDAQ OMX PHLX, NYSE Amex, NYSE Arca, and The Options Clearing Corporation (“the Options Exchanges”) appreciate the opportunity to comment on File No. S7-08-09 (the “Release” or “Proposing Release”) amending Regulation SHO, the Securities and Exchange Commission’s (“Commission”) primary regulation governing short sales.<sup>1</sup> In the Release, the Commission asks whether, in light of recent market events, it is necessary and appropriate to restore “price test” restrictions on short sales which were eliminated in their entirety in 2007. The Commission proposes two broad approaches to restrictions on short selling. The first is a price test that would apply on a market wide and permanent basis. The Commission proposes two alternative short sale price tests: one based on the national best bid (“proposed modified uptick rule”) and one based on the last sale price (“proposed uptick rule”). The second approach is a circuit breaker that would apply only to a particular security during severe price declines in that security. The Commission proposes three alternatives with respect to circuit breakers. The first is a short sale halt, the second is a circuit breaker that would trigger a price test based on the national best bid in the security, and the third is a circuit breaker that would trigger a price test based on the last sale price in the security.

Our comment letter focuses on the impact that these alternatives would have on options market makers. We note that only the trading halt alternative contains an exemption for

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<sup>1</sup> Securities Exchange Act Release No. 59748 (April 10, 2009), 74 Fed. Reg. 10842 (April 20, 2009).

options market makers and we strongly urge the Commission to maintain that exemption if it chooses to adopt this alternative. In addition, the Options Exchanges strongly believe that an exemption for options market makers is essential if the Commission chooses to restrict short sales by adopting any of the other alternatives. Without an exemption for options market makers who are short selling to hedge the exposure that arises from bona fide market making, we believe that these alternatives would significantly harm the ability of options market makers to respond to customer demand with narrow bid/ask spreads and ample liquidity. The result would be harm to investors.

The Options Exchanges commend the Commission for the thoughtful, deliberative approach that it is taking on the important issue of whether to reinstate short sale price tests, and if so, what approach would best restore investor confidence while maintaining market efficiency. We are aware that the Commission has received numerous requests from investors, issuers and members of Congress to reinstate short sale price tests. In light of the significant price declines in the latter portion of 2008, we agree that taking steps to restore investor confidence are extremely important. The Commission notes in the Proposing Release that it “has long held the view that short selling provides the market with important benefits, including market liquidity and pricing efficiency.”<sup>2</sup> The Commission also expressed concern that “unrestricted short selling could exacerbate a declining market in a security by increasing pressure from the sell side.”<sup>3</sup> In our view, the Commission has already taken significant and effective action over the past nine months to restrict potentially abusive short selling.

First, the Commission adopted an anti-fraud rule directed at naked short selling<sup>4</sup> that should aid enforcement efforts. The Commission also imposed enhanced delivery requirements for all equity securities in Rule 204T on an emergency basis.<sup>5</sup> A slightly amended version of Rule 204T was adopted by the Commission on an interim final temporary basis on October 14, 2008.<sup>6</sup> Rule 204T generally provides for delivery of equity securities on settlement date or the close-out of any fail to deliver position on settlement date by the next settlement date. The Rule contains a limited exception for market makers, including options market makers, engaged in bona fide market making activity, permitting them to close out any fail to deliver position by the beginning of trading on the third settlement date following the settlement date.<sup>7</sup> If fails are not closed

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<sup>2</sup> Exchange Act Release No. 59748, 74 Fed. Reg. 18042, 18044.

<sup>3</sup> Id.

<sup>4</sup> Exchange Act Release No. 58774 (Oct. 14, 2008), 73 Fed. Reg. 61666 (Oct. 17, 2008).

<sup>5</sup> Exchange Act Release No. 58572 (Sept. 17, 2008), 73 Fed. Reg. 54875 (Sept. 23, 2008).

<sup>6</sup> Exchange Act Release No. 58773 (Oct. 14, 2008), 73 Fed. Reg. 67106 (Oct. 17, 2008). Rule 204T remains in effect until July 31, 2009 unless the Commission acts to make it permanent before then.

<sup>7</sup> The Options Exchanges filed a comment letter on Rule 204T urging the Commission to extend slightly the time to resolve fails for all market participants to five days after settlement date and to close out any fails by no later than the end of regular trading hours on that day. Comment letter of Boston Options

out in compliance with Rule 204T, significant limitations on the ability to engage in short sales go into effect. The Commission also eliminated the options market maker exception from the close-out requirements for threshold securities.<sup>8</sup> While the Options Exchanges continue to support some modifications to Rule 204T to better balance concerns about potentially abusive short selling against the need for market efficiency, we agree that the settlement discipline imposed by Rule 204T removes a potentially potent tool from abusive short sellers. The Commission's Office of Economic Analysis (OEA) recently studied the impact of these changes and found that they have been successful in drastically reducing fails overall, as well as the number of threshold securities. Among other things, OEA's most recent studies shows that fails declined by 56.6% across all securities and 73.5% for threshold stocks, and that the average daily number of threshold securities decreased by 77.5%, with those threshold securities with listed options decreasing by 82.1%.<sup>9</sup>

Finally, the Commission issued an interim final temporary rule requiring disclosure of short sales and short positions in certain securities. The disclosure regime places vital information about short sales in the hands of the Commission.<sup>10</sup> The Options Exchanges strongly feel that the Commission should not minimize the power of these profound changes to rein in abusive short selling when it assesses whether further restrictions on short selling are warranted.

The Options Exchanges do not have a consensus view on whether the Commission should reinstate a price test and, if so, which of the alternatives proposed by the Commission should be pursued. However, we all strongly agree that if the Commission does adopt a price test for short sales, it is imperative that options market makers receive an exemption when they are shorting stock to hedge exposure that results from bona fide market making activity. Failure to grant an exemption will harm the options markets by increasing bid/ask spreads and diminishing liquidity, to the detriment of public investors in the options markets.

Market makers are a vital part of the thriving U.S. options markets which serve the risk management needs of a growing number of customers.<sup>11</sup> While fewer than 8,000 stocks are traded in the U.S., nearly 340,000 individual options are traded on U.S. exchanges. Only a very small number of these options have enough natural buy/sell interest to support any customer-to-

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Exchange, Chicago Board Options Exchange, International Securities Exchange, NASDAQ Options Market, NASDAQ OMX PHLX, NYSE Alternext US [Amex], NYSE Arca and The Options Clearing Corporation (December 19, 2008) at 3.

<sup>8</sup> Exchange Act Release No. 58775, 73 Fed. Reg. 61690 (Oct. 17, 2008).

<sup>9</sup> Memorandum from Office of Economic Analysis Re: Impact of Recent SHO Rule Changes on Fails to Deliver, April 16, 2009 at <http://www.sec.gov/comments/s7-30-08/s73008121.pdf>.

<sup>10</sup> Exchange Act Release No. 58785 (Oct. 15, 2008), 73 Fed. Reg. 61678 (Oct. 17, 2008). The interim temporary final rule expires on August 1, 2009 unless the Commission makes it permanent before then.

<sup>11</sup> Through May 2009, 1,499,660,142 options contracts were traded on our exchanges this year. This represents a 4.7% increase over last year's volume at the same point.

customer trading. Options market makers provide two-sided markets in all of the available options and stand ready to take the other side of customer orders. When options market makers respond to customer demand by buying calls or selling puts, they have exposure that can only be hedged by shorting stock.<sup>12</sup> These trades are not manipulative nor intended to destabilize the price of the stock. If an options market maker knows that he may not be able to establish a hedge position because an uptick rule or modified uptick rule is in effect, he will likely protect himself by widening his quotes or posting less size. Investors will inevitably feel the impact of this response to an inability to hedge because they are usually trading with options market makers. An investor who enters an options position has a reasonable expectation that he or she will be able to close out that position at a competitive price. Imposing a price test at a time of stress inevitably will lead to market makers providing inferior prices just when investors most need liquidity. Inferior prices and compromised liquidity at a time of stress are likely to undermine investor confidence.

The Commission has recognized the central role that options market makers play many times since the adoption of Reg. SHO. The Commission's decision not to include an exemption from most of its proposed alternatives inexplicably runs counter to its past actions. Most recently, the Commission provided exemptions for options market makers from several emergency orders issued in the past year.<sup>13</sup> The Commission exempted market makers, including options market makers, from the September 2008 emergency order banning short sales in the securities of certain financial firms "to permit market makers to continue to provide liquidity to the markets."<sup>14</sup> The Commission also exempted bona fide market makers, including options market makers, from the borrow and arrangement-to-borrow requirements of the Commission's July 2008 emergency order regarding the securities of certain financial companies "to permit market makers to facilitate customer orders in a fast-moving market without possible delays associated with complying with the borrow and arrangement-to-borrow requirement of the Order."<sup>15</sup> The Commission used the same reasoning to exempt options market makers from the "locate" requirement of Reg. SHO.<sup>16</sup> The Proposing Release articulates no reason for the Commission to abandon its prior decisions on options market makers. The Options Exchanges feel strongly that the rationales justifying these exemptions for options market makers are equally applicable in the context of the price test alternatives proposed by the Commission.

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<sup>12</sup> Options market makers do not establish a short stock position that corresponds one-to-one with each options position that they create in response to customer demand. Rather, options market makers take hedge positions based on the risk (e.g., a delta neutral stance) of the options positions on their book.

<sup>13</sup> Securities Exchange Act Release No. 58611 (Sept. 21, 2008), 73 Fed. Reg. 55556 (Sept. 25, 2008); Securities Exchange Act Release No. 58190 (July 18, 2008), 73 Fed. Reg. 42837 (July 23, 2008).

<sup>14</sup> Securities Exchange Act Release No. 58611, 73 Fed. Reg. at 55556.

<sup>15</sup> Securities Exchange Act Release No. 58190, 73 Fed. Reg. at 42837.

<sup>16</sup> Securities Exchange Act Release No. 50103 (July 28, 2004), 69 Fed. Reg. 48008 (Aug. 6, 2004) at 48015.

In the Proposing Release, the Commission states that it preliminarily believes that the modified uptick rule based on the national best bid would have an advantage over the uptick rule based on the last sale price in today's markets.<sup>17</sup> The modified uptick rule that the Commission is considering is based on the NASD's<sup>18</sup> bid test in effect prior to the adoption of Reg. SHO. We agree that recent market developments, such as the implementation of Reg. NMS and the proliferation of execution venues, make today's equities markets more like the dealer market in which the NASD bid test operated than the centralized market in which SEC Rule 10a-1 operated. Thus, the fact that Rule 10a-1 did not contain an exemption for options market makers is less relevant than the fact that the NASD bid test did contain such an exemption. In 1994, the Commission approved an exemption from the NASD bid test for "exempt hedge transactions" by "qualified options market makers" that are registered with a "qualified options exchange," finding that an exemption for legitimate hedging transactions by options market makers would minimize the potential adverse impacts on the options markets.<sup>19</sup> The Commission has not cited any reason why the same exemption would not be included in a Commission rule modeled closely on the NASD bid test.

To qualify for the NASD bid test exemption, the short sale had to be an "exempt hedge transaction," defined as a short sale that is "effected to hedge, and in fact serves to hedge, an existing offsetting options position or an offsetting options position that was created in a transaction(s) contemporaneous with the short sale, provided that when establishing the short position the options market maker is eligible to receive(s) good faith margin pursuant to Section 220.12 of Regulation T under the Act for that transaction." The short sale had to be effected by a "qualified options market maker," which is "an options market maker who has received an appointment as a 'qualified options market maker' for certain classes of stock options . . . pursuant to the rules of a qualified options exchange." A "qualified options exchange" is a national securities exchange that has approved rules and procedures providing for: (1) the designation of qualified options market makers; (2) surveillance of market makers' use of the exemption; and (3) authorization of the NASD to withdraw, suspend, or modify the designation in the event that the options exchange determines that a qualified options market maker has failed to comply with the terms of the exemption and such action is warranted in light of the substantial, willful, or continuing nature of the violation.

At the time that the Commission considered whether to approve the exemption, it noted that that in light of the safeguards proposed in conjunction with the exemption, the NASD did not believe that the exemption would "subsume or eviscerate the effectiveness of the NASD's short sale rule." The NASD also noted that the Intermarket Surveillance Group Agreement among and between the NASD and the options exchanges (among others) would "help ensure that the options market maker exemption will not have an

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<sup>17</sup> Securities Exchange Act Release No. 59748, 74 Fed. Reg. at 18049.

<sup>18</sup> NASD is now known as FINRA. The NASD bid test only applied to NASDAQ stocks.

<sup>19</sup> Securities Exchange Act Release No. 34277, 59 Fed. Reg. 34885 (July 7, 1994).

adverse market impact on Nasdaq” and would “serve as an effective vehicle for the markets to evaluate possible manipulative activity and other possibly market destabilizing short selling activity by qualified options market makers and other options market makers in Nasdaq securities.”<sup>20</sup>

An exemption for options market makers would also be consistent with the principles for the effective regulation of short selling recently articulated by the Technical Committee of the International Organization of Securities Commissions (“IOSCO”).<sup>21</sup> The report lays out four principles for the effective regulation of short selling. Many of the steps that the Commission has already taken to regulate short selling, including adopting Rule 204T and short sale disclosure requirements are consistent with the principles. The four principles are:

- (1) Short selling should be subject to appropriate controls to reduce or minimize the potential risks that could affect the orderly and efficient functioning and stability of financial markets.
- (2) Short selling should be subject to a reporting regime that provides timely information to the market or market authorities.
- (3) Short selling should be subject to an effective compliance and enforcement system.
- (4) Short selling regulation should allow appropriate exceptions for certain types of transactions for efficient market functioning and development.

In discussing the fourth principle, the IOSCO report includes market making as one of the activities which should be considered for exemption from “price restriction rules” since market making, among other activities, “generally provide[s] benefits to the market and [is] unlikely to pose risks that will destabilize the market.”<sup>22</sup> The IOSCO Report provides support for our contention that an exemption from the short sale restrictions proposed by the Commission is appropriate.

In sum, the Options Exchanges believe that the failure to include an options market maker exemption in a short sale price restriction rule would adversely affect our markets in a serious manner. Such a failure would run counter to repeated Commission actions to include an options market maker exemption over the past several years. Moreover, we are not aware of any well-founded empirical evidence to justify the omission of an exemption, particularly as the omission would result in significant harm to the options markets.

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<sup>20</sup> Securities Exchange Act Release No. 33289, 58 Fed. Reg. 64994 (Dec. 10, 1993).

<sup>21</sup> Regulation of Short Selling, Final Report, Technical Committee of the International Organization of Securities Commissions (June 2009).

<sup>22</sup> Id. at 18.

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Lastly, we note that the Commission has proposed an exception for options assignments and automatic exercises under the circuit breaker halt alternative but not explicitly under the price test alternatives. We find the inclusion of the exception solely for the circuit breaker halt alternative confusing. The Commission should clarify that all short sales that result from assignments and exercises (whether or not automatic) would be excepted from any circuit breaker halt or price test that may ultimately be adopted. It is possible that the Commission did not mention a specific exception for exercises and assignments, due to the fact that they take place in the after hours market when the proposed price tests would not be applicable. We see no reason to distinguish exercise and assignment activity from any other after hours activity, and recommend that the Commission make it clear that it did not intend to capture exercises and assignments occurring after hours in any proposed price test. Even if the Commission decides that the proposed price tests should apply to after hours trading, we believe that there are reasons exercises and assignments should not be covered. Among other things, exercises and assignments take place at a fixed strike price that is not determined in relation to the current market price. This is not unlike passive pricing systems that effect trades at independently-derived prices (such as mid-point pricing systems) for which the Commission is also proposing an exemption. Similarly, stock sales from exercises and assignments would not exert downward pressure on the underlying stocks that any proposed price test is arguably designed to prevent in that the sales are affected at a previously established price based on a strike price and are expressly excepted from trade reporting requirements and not included in trades disseminated on the transaction tape during regular trading hours. This was, in fact, the reason why exercises and assignments were not covered by the former Rule 10a-1 price test; there is no reason for the Commission to adopt a different approach now.

Thank you again for the opportunity to comment on the Commission's proposal to restrict short sales by adopting a market wide price test or a security specific circuit breaker. If you would like to discuss any of the issues raised in this letter, please contact Susan Milligan at The Options Clearing Corporation at (202) 756-1972.

Sincerely,

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Chicago Board Options Exchange  
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NASDAQ Options Market  
NASDAQ OMX PHLX  
NYSE Amex  
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The Options Clearing Corporation

cc: James A. Brigagliano  
Daniel Gallagher