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September 21, 2009

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 Commission's re-proposal regarding short sale regulation.[1] This letter supplements our original letter on the Commission's short sale proposals.[2] The Commission is requesting comment on an "Alternative Uptick Rule," which would allow short selling only at a price above the current national best bid ("NBB").[3] The Commission requests comment on: the Alternative Uptick Rule generally; its application either full-time or as a "circuit breaker" upon a severe decline in the price of a security; and whether there should be a market maker exception to such a rule.

ISE reiterates its positions discussed in its Initial Letter: The Commission should act cautiously and not impose any further short sale regulations on the investment community at this time. 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. However, if the Commission determines that it must take action, we recommend that the Commission adopt the Modified Uptick Rule, on a circuit breaker basis, while exempting options market makers from that test for hedging transactions. We do not support the Alternative Uptick Rule.

## The Costs of the Alternative Uptick Rule Outweigh Its Benefits

Consistent with our general position that we do not believe that further regulation of short sales is necessary at this time, we believe that if the Commission does adopt additional restrictions on short sales, such restrictions should be as limited as possible.

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[1] Release No. 34-60509 (August 17, 2009); 74 F.R. 42033 (August 20, 2009) (the "Release").
[2] Letter from Michael Simon, Secretary, ISE, to Elizabeth Murphy, Secretary, Commission, dated June 19, 2009 ("Initial Letter").
[3] The Commission previously had proposed an "Uptick Rule," limiting short sales based on the last sale price of a security, and the "Modified Uptick Rule," limiting short sales based on the changes in the NBB.

The Commission recognizes that, "the alternative uptick rule would restrict short selling to a greater extent than either the proposed modified uptick rule or the proposed uptick rule." However, the Release does not provide an explanation as to why a greater degree of short sale regulation than the Uptick or Modified Uptick Rules is needed. The only rationale discussed in the Release is that the Alternative Uptick Rule would be easier to implement "because it would not require monitoring of the sequence of bids or last sales prices...." We do not believe that "ease of implementation" is a sufficient rationale to adopt a rule that, when implemented, would have a more disruptive effect on the market than other possible approaches to short sale regulation.

We believe it is insufficient only to look narrowly at certain explicit costs in implementing a rule, such as the programming and preparatory costs. The true costs of any regulation are the effects the regulation will have on the market subject to that regulation. As the Commission properly notes, the Alternative Uptick Rule will restrict short sales to a greater extent than the other Commission proposals. In this regard, the Commission has recognized the benefits of short sales,[4] and clearly states that this test will restrict those benefits to a greater degree than the Uptick Rule or Modified Uptick Rule. The discussion in the Release – and the comment letters submitted thus far in response to the Release – give no indication that there are any long-term benefits to the Alternative Uptick Rule that outweigh the market impact of that test.

We also believe that commenters overstate the costs of implementing the Uptick Rule and Modified Uptick Rule. In fact, the industry already has implemented both of these tests. Commission Rule 10a-1 imposed a last sale-based tick test on listed stocks, while the NASD imposed a bid-based tick test on Nasdaq-traded stocks. These rules were in effect at the same time, and market participants were able to comply with both tests in that dual environment. Thus, we see even fewer practical issues if the Commission were to require market participants to comply with only one of these rules.

We are also concerned that the Commission has not fully analyzed the effects that the Alternative Uptick Rule could have on the market. Indeed, we believe that this test could have unintended consequences. The Commission states in the release that the Alternative Uptick Rule "would not allow short sales to get an immediate execution, even in an advancing market...."[5] The Commission appears to be assuming that the only way a person could execute a short sale under the Alternative Uptick Rule would be to place an offer to sell short on a market's limit order book, and wait for someone to take that offer.

We can envision a variety of other ways in which legitimate, immediate short sales could occur under the Alternative Uptick Rule: a firm could provide price improvement for an order at a price above the NBB and print the trade on the Alternative Display Facility operated by the Financial Industry Regulatory Authority; an order could receive price improvement by being exposed to other trading interest on an exchange; or an order could be executed in a facility providing executions in the middle

[4] See our Initial Comment Letter at note 2.
[5] Release at page 6.

of the bid-asked spread, such as the ISE Stock Exchange's MidPoint Match facility.[6] Thus, we are concerned that the Commission has not fully considered how this test would actually work in the market.

We also believe that the market will adapt to the Alternative Uptick Rule and devise other trading strategies to effect short sales under such a regulation. This could lead to unintended and unanticipated effects on markets that currently are operating very efficiently. We see no reason for the Commission to adopt an untested new short sale restriction that will impose greater burdens on the market when the market has experience working with the two other rules that impose fewer restrictions.

<u>The Commission Should Limit the Applicability of Any New Short Sale Regulation</u>

Because the Alternative Uptick Rule is so restrictive, we believe that if the Commission adopts this test it is critically important for the Commission to limit the applicability of such a rule by applying it only as a circuit breaker. As we discussed in our Initial Letter, we believe that any circuit breaker-based test should have a trigger of at least a 20 percent price decline in a security. This is especially important with the Alternative Uptick Test, whose restrictions would limit short sales – and the benefits of such sales – to a significantly greater extent than the other two tests.

We also reiterate our support for an options market maker exemption for any test the Commission may apply, and in particular the Alternative Uptick Rule. In this regard, the Commission acknowledges that the Alternative Uptick Rule "would be more restrictive than the proposed modified uptick rule," and renews its request for comment on an exception and the "conditions that should be imposed to ensure that it is used only for bona fide market making purposes."[7]

The Alternative Uptick Rule will severely restrict the ability of market participants to sell short, in many cases effectively prohibiting such sales. As discussed in our Initial Letter, liquidity is spread over many more products in the options market, resulting in less natural customer order flow concentrated in any single product. Indeed, 98 percent of the quoted size in our market represents market maker quotes. If options market makers are unable to hedge their positions by selling short when they buy calls or sell puts, liquidity will be extremely hampered. Thus, an exception is absolutely necessary for options market makers if the Commission adopts any of the three proposed tick tests, and especially for the most restrictive tick test, the Alternative Uptick Rule.

Our Initial Letter discusses the two conditions we believe are appropriate for any options market maker exception. First, an options exchange needs to appoint the person to act in the role of a market maker on the exchange pursuant to Commission-approved market making rules. Second, the exemption should be limited to an options market maker's legitimate hedging activities. Short sale regulation is intended to protect against fraud, and hedging activity is not fraudulent. Thus, when a person registered as

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[6] *E.g.*, ISE Rule 2129.
[7] Release at page 10.

an options market maker engages in legitimate hedging activity that person should be exempt from any of the proposed short sale tick tests.

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We continue to believe that: (i) no further short sale regulation is necessary at this time; and (ii) if the Commission adopts any rule, it should be the Modified Uptick Rule, applied as a circuit breaker and with an options market maker exception. We believe adopting the Alternative Uptick Tick in any fashion raises significant issues and should not be considered further by the Commission. 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