

James J. Roth
Tucson, Arizona

April 30, 2007

Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: **SEC Release No. 34-55520** (File No. S7-12-06)
Proposed Amendments to Regulation SHO

Dear Ms. Morris,

I respectfully submit the following comments with respect to SEC Release No. 34-55520; File No. S7-12-06 (Amendments to Regulation SHO), in which the Securities and Exchange Commission (the "Commission") proposes Amendments to Regulation SHO.

I commend the Commission for working to keep a fair playing field in the United States equity markets by addressing "naked" short selling in Regulation SHO and feel that the Commission's review of Regulation SHO at this point over 3 ½ years after its initial effective date is both valid and prudent. However, the United States securities markets are some of the most innovative and liquid in the world, and I would not want to see unneeded regulation, as it relates to exchange traded funds (ETFs), hurt the ability of investors and traders to use these innovative instruments of our capital markets.

My comments are all made exclusively as to how Regulation SHO relates to ETFs. I wish to make a case for either (i) an expressed exception from the locate and delivery requirements of Regulation SHO for transactions in ETFs (ii) or to the extent that the Commission feels the benefits of having these regulations on ETFs outweigh the costs, I urge the Commission to raise the threshold security¹ limit for ETFs from 0.5% to 2.0% of the ETF's total outstanding shares. In no case tighten the "grandfather" provision on ETFs, which excepts fails to deliver established prior to a security becoming a threshold security; and in no case tighten the "options market maker exception" on ETFs, which excepts any fail to deliver in a threshold security resulting from short sales effected

¹ SEC Amendments to Regulation SHO dated July 14, 2006 File no. S7-12-06 "A threshold security is defined in Rule 203(c)(6) as any equity security of an issuer that is registered pursuant to section 12 of the Exchange Act (15 U.S.C. 78l) or for which the issuer is required to file reports pursuant to section 15(d) of the Exchange Act (15 U.S.C. 78o(d)) for which there is an aggregate fail to deliver position for five consecutive settlement days at a registered clearing agency of 10,000 shares or more, and that is equal to at least 0.5% of the issue's total shares outstanding; and is included on a list disseminated to its members by a self-regulatory organization ("SRO"). 17 CFR 242.203(c)(6). This is known as the "threshold securities list." Each SRO is responsible for providing the threshold securities list for those securities for which the SRO is the primary market."

by a registered options market maker to establish or maintain a hedge on options positions that were created before the underlying security became a threshold security.

I am currently a private investor and trader mainly trading ETFs. I have had over 25 years experience in the financial sector working for large institutional buy side and sell side accounts, as well as working on the securities sales desk of a large U.S. Government agency in Washington, DC. My roles during my career have variously included buying and selling fixed income and equity securities and derivatives, as well as managing securities trading and sales desks.

Much has changed in the securities industry in the last 25 years, and I feel much has changed for the better. Small private investors and traders now have opportunities for investment and trading that only large institutional firms once had. I feel one of the greatest new products that has helped level the playing field for small investors / traders has been the advent of ETFs. ETFs now allow small investor / traders to go long and to go short specific sector baskets of stocks, commodities, currencies, etc. One of the great benefits of ETFs is the ability to invest or trade a sector without having to worry about specific company event risk. As we all know, there has been a lot of individual company event risks over the last 6 years. Picking an equity ETF with over 20 securities in a single sector helps significantly reduce one's company risk, while allowing one to benefit from the overall sectors performance. The ability to go short sectors through ETFs is something relatively new because most mutual funds (the other way for small investors to diversity) only allow long trades. A small investor / trader using prudent risk management can affect their own personal long / short hedge strategy with the very liquid sector ETFs that are available in the U.S. equity markets today. Due to the component nature of ETFs, attempts to manipulate an individual stock by the use of an ETF would be economically futile.² The previous statement assumes the requirements of the recent

² As stated in the letter dated October 24, 2006 from Stuart M. Strauss of Clifford Chance US LLP to James A. Brigagliano referenced in and attached to James A. Brigagliano's No-Action Letter File No. TP 07-07 dated October 24, 2006.

"A primary purpose of Rule 10a-1 is to prevent the market price of a stock from being manipulated downward by unrestricted short selling. The market prices of Shares will fluctuate in accordance with changes in net asset value and supply and demand on the Amex. Price differences may be due, in large part, to the fact that supply and demand forces at work in the secondary trading market for Shares will be closely related to, but not identical to, the same forces influencing the prices of the component securities of the Index trading individually or in the aggregate at any point in time. Any temporary disparities in market value between Shares and the relevant component securities would tend to be corrected immediately by arbitrage activity. Moreover, Shares in Creation Unit aggregations or multiples thereof may be redeemed through the Trust on any Business Day principally for a distribution of shares of Fund Securities. Under these circumstances, it would appear to be economically futile for short sales in Shares to be utilized to depress Share prices. Moreover, it would similarly be economically futile for short sales in Shares to be utilized to depress particular stocks in their respective Index. Each Index is large enough that it would be economically futile to attempt to use short sales to depress particular index stocks. Currently, no single stock comprises more than 10% of each of the Listed Private Equity Index and the WHPS(SM) Financial Index. Therefore, a short seller with manipulative intent must spend at least \$10 for every \$1 of market impact. The economic impracticality of such a strategy is apparent. The trading market for Shares would be adversely affected if Rule 10a-1 operated to prevent dealers or exchange specialists from making short sales of Shares to satisfy customer demand in the absence of an uptick. Requiring an investor to utilize

October 24, 2006, Class Relief for Exchange Traded Index Funds No-Action letter requirement that no single stock can comprise more than 25% of the fund, and the ETF has the ability to issue creation units.

I plan to comment on the following questions raised by the Commission in the Amendment to Regulation SHO file number S7-12-06.

“Some market participants have suggested that delivery failures in certain structured products, such as exchange traded funds (ETFs) do not raise the same concerns as fails in securities of individual issuers. We also understand that there may be particular difficulties in complying with the close-out requirements because of the structure of these products. Are there unique challenges associated with the clearance and settlement of ETFs? If so, what are these unique challenges? Should ETFs or other types of structured products be exempted from being considered threshold securities? If so, what reasons support excepting these securities?”

Based upon my experience and analysis of the markets there are numerous compelling reasons to support excepting ETFs from the locate and delivery requirements of Regulation SHO.

1. ETFs can be continually created and redeemed through the daily issuance or redemption of creation units.
2. ETFs are derivative in nature and are generally comprised of multiple component securities that are based on an index.
3. ETFs have been granted exemptions from Rule 10a-1 because it would appear that trading in an ETF's shares would not be susceptible to the practices that Rule 10a-1 is designed to prevent. Rule 10a-1 is designed to prevent the market price of a stock from being manipulated downward by unrestricted short selling.
4. It would be economically difficult to affect the shares on a single stock in an index that the ETF is tracking because that stock would normally be less than 25% of the ETF and in most cases less than 10% of the ETF.
5. Amex³, Nasdaq⁴, NYSE⁵ and SIA⁶, all agree with excepting these securities from being threshold securities for the reasons above.

another means to achieve such investor's investment goals would be detrimental to the market for Shares and contrary to the public interest in liquid, efficient securities markets.”

³ Amex comment letter on File no. S7-23-03 to the SEC on February 20, 2004. “Finally, the Amex believes that an exception to the locate and delivery requirements of Regulation SHO should also be codified for ETFs. ETFs are not currently subject to such requirements due to the unique characteristics of the securities, which provide the capability for the shares to be continuously created and redeemed in-kind.

6. ETFs make up 47% of Amex's daily Regulation SHO threshold security list which is obviously a significant number. Tightening Regulation SHO rules on ETFs can exacerbate this problem, thereby keeping small investor / traders from being able to use these products for hedging and trading, yet providing no added regulatory benefit.

"Fails," consequently, can be closed-out through the creation of ETFs and the delivery of the securities to the clearing corporation."

⁴ Nasdaq comment letter on File no. S7-23-03 to the SEC on March 25, 2004. "... NASDAQ believes there should be an exception to the locate and delivery requirements of Regulation SHO for ETFs. Because ETF shares can be continuously created and redeemed in-kind, open clearing positions can be closed-out through the creation of ETFs and the delivery of securities to the clearing corporation."

⁵ Comment letter to File no. S7-12-06 dated September 22, 2006 from NYSE/Arca and many other exchanges; "Many of the threshold securities with active options trading are ETFs. The Commission asks whether ETFs should be excepted from being considered threshold securities. We support this approach because new ETFs shares can always be created to alleviate the shortage that leads to fails to deliver. In addition, short selling of ETFs does not raise the same confidence issues as abusive short selling of a company's stock."

⁶ Securities Industry Association ("SIA") comment letter on File no. S7-12-06 dated September 19, 2006. "C. Exception From the Close-out Requirement for ETFs and Structured Products. The Proposing Release asked a question whether ETFs or other types of structured products should be excepted from the Reg SHO definition of "threshold securities," noting the concerns expressed by market participants that delivery failures in such products do not raise the same concerns as fails in securities of individual issuers, and that there may be unique challenges associated with the clearance and settlement of such products. In response, SIA believes that the Commission should indeed provide an exception from the definition of threshold security for ETFs, as well as structured products, and closed-end funds. Evidence reveals that a sizeable percentage of threshold securities (especially those from the NYSE and AMEX) consist of such products. SIA believes that these significant percentages may be related to the fact that the calculation of threshold securities does not readily translate to these products, specifically because such calculation presupposes a fixed amount of total shares outstanding (i.e., the aggregate fail-to-deliver must be at least 10,000 shares and equal to at least 0.5% of the total shares outstanding). Unlike issuers of common stock, ETFs do not have such a fixed number of total shares outstanding. Although a fixed amount of ETFs may be delivered by a broker-dealer to a depository for creation, additional ETFs will be created by other market participants on an ongoing basis. Reg SHO's formula does not appropriately take into account this characteristic of ETFs and the appearance of ETFs on the threshold security lists also does not reflect a level of fails that are indicative of chronic delivery problems.

Furthermore, from a policy perspective, ETFs do not necessarily present the same concerns with respect to potential manipulative short selling activities, given the fact that the value of ETFs is derived from the market prices of the underlying basket. In this regard, we believe it notable that the definition of threshold securities does not cover other derivative securities, such as options, and the Commission has expressly noted, in granting relief from the "tick" test (as well as certain other rules) for many ETFs and structured products, that the derivative nature of these products do not lend themselves to abuse. Moreover, to the extent short sales may cause disparities between the price of an ETF and the price of the underlying basket, this creates arbitrage opportunities, which should result in the price discrepancy being eliminated (e.g., any short sales and fails of sufficient size to suppress the price of the ETF relative to the basket should result in buying interest since one could buy the ETF and convert it into the basket and sell the stock). SIA firms are unaware of any abusive or manipulative activity which has been linked to fails in ETFs. Furthermore, to the extent there are fails in ETFs, new ETFs can always be created in order to make delivery on an open fail situation. Based on the above factors, it is not believed that excluding ETFs, structured products, and closed-end funds from the definition of threshold securities will constitute a controversial amendment."

7. The daily creation and redemption of creation units in some ETFs can dwarf the small 0.5% threshold limit. Regulation SHO's formula does not take this into account. So it does not appear that this rule works as expected with ETFs.

The Commission has continually stated that Regulation SHO only affects a very small percentage of securities outstanding.⁷ While this is true when the entire stock market is taken into account, this does not appear to be true in regards to ETFs. I have picked Amex's Regulation SHO threshold securities list to analyze because Amex lists the largest number of ETFs of any exchange.

In regards to the letter from the NASDAQ dated March 12, 2007, which the Commission is using as evidence that the current Regulation SHO rules are not working; the Commission only took 149 trading days into account in that summary. I have taken 580 trading days into account in analyzing Amex's list of threshold securities from 1/7/2005 to 4/27/2007. Based on my analysis of the Amex daily Regulation SHO threshold securities list, it appears that ETFs are being unfairly targeted by this regulation. My summary is as follows.

- No Amex securities have been listed continually on the threshold list since the lists inception on 1/07/2005.
- 705 Amex securities have been on the threshold list at some time during the period and 236 of these are ETFs.
- The average number of total securities on Amex's daily threshold list is 55 securities and of those 55 securities 26 securities on average are ETFs.
- 47%, on average, of all securities listed daily on Amex's threshold list are ETFs.
- 7%, on average, of all Amex's listed ETFs are on the threshold list daily.⁸

These numbers are significant and seem to illustrate a problem with the Commission's Regulation SHO rules as they relate to ETFs. I would suggest the Commission further review ETF data before tightening restrictions on them and exacerbating this problem. If the Commission would like to review my data please contact me at the phone number listed at the end of this document.

⁷ SEC Amendments to Regulation SHO, File No. S7-12-06. "The average number of securities on the threshold list in May 2006 was approximately 298 securities, which comprised 0.38% of all equity securities, including those that are not covered by Regulation SHO."

⁸ Amex lists 371 securities currently on its ETF and Holders lists.

Below I give an example of the nine ETFs in the Select Sector SPDRs family of funds with a combined daily trading volume of over 45 million shares. These ETFs have been listed since 1998. Much of the data in this chart comes from Amex's website.

Symbol	Market Capitalization (billions)	Shares Outstanding (millions)	April Shorts (millions)	Average Daily Volume (millions)	Days To Cover	On the Reg SHO Threshold List*	Reg SHO Threshold Limit Shares**	Vol % of Thre.***
XLE	\$4.1	64.4	45.9	17.8	2.6	33%	322,000	2%
XLY	\$0.7	18.9	11.1	1.2	9.3	30%	94,500	8%
XLF	\$3.1	83.6	47.2	12.2	3.9	22%	418,000	3%
XLB	\$1.1	26.8	13.9	3.3	4.2	20%	134,000	4%
XLU	\$3.6	80.2	10.2	3.1	3.2	14%	401,000	13%
XLI	\$1.3	34.6	11.5	3.1	3.7	7%	173,000	6%
XLV	\$2.0	56.1	13.0	1.6	8.6	4%	280,500	18%
XLK	\$2.6	87.4	8.6	1.5	5.6	2%	437,000	29%
XLP	\$1.8	64.3	6.9	1.3	5.3	2%	321,500	25%
Totals	\$20.3	516.3	168.30	45.1				

* This is the percentage of days that the symbol is on the Regulation SHO threshold securities list. (i.e. XLE was on the list 189 days out of 580 trading days or 33% of the time.)

** This is the calculation of the threshold security number of shares specified in Rule 203(c)(6). (i.e. XLE had 64.4 million total shares outstanding * 0.5% = 322,000 shares.) So if XLE has 322,000 shares fail to deliver for five consecutive settlement days it goes on the threshold securities list.

*** This is the threshold limit number of shares divided by the average daily volume of the security. (i.e. XLE had a threshold limit of 322,000 shares divided by the 17,800,000 share average daily volume which equaled 1.8% or rounded to 2.0%.) It appears that the lower this percentage the higher likelihood that the security will go on the threshold security list. This unfairly targets high volume ETFs with no regulatory benefit.

It would appear from the chart above that there were plenty of shares to borrow to short. So it does not appear that "naked" short selling is the cause of the high level of listing on Amex's threshold security list. Also generally the larger the trading volume as a percentage of the threshold limit, the more likely the security goes on the threshold list. There are many reasons that broker-dealers may justifiably experience problems with settling large volumes of trades.⁹ The locate and delivery requirements of Regulation SHO seem to unfairly target active ETFs. I would imagine a reason is that many of the shares in active ETFs are bought and sold the same day and would be paired off at settlement three days later. In the Rule there is currently no exemption for securities that are paired off.

⁹ From SEC Key Points about Regulation SHO dated April 11, 2005, "There are many justifiable reasons why broker-dealers do not or cannot deliver securities on settlement date. A broker-dealer may experience a problem that is either unanticipated or is out of its control, such as (1) delays in customers delivering their shares to a broker-dealer, (2) the inability to obtain borrowed shares in time for settlement, (3) issues related to the physical transfer of securities, or (4) the failure of a broker-dealer to receive shares it had purchased to fulfill its delivery obligations. Fails to deliver can result from both long and short sales."

The following table breaks down the Select Sector SPDRs by the percentage of each year that they were on the Amex Regulation SHO threshold security list.

Percentage of time the Security is on the Daily Amex Regulation SHO Threshold Security List				
Symbol	2005 On List	2006 On List	2007 ¹⁰ On List	All Years
XLE	52%	19%	17%	33%
XLY	42%	21%	21%	30%
XLF	36%	3%	34%	22%
XLB	14%	22%	32%	20%
XLU	21%	8%	11%	14%
XLI	6%	0%	29%	7%
XLV	2%	6%	0%	4%
XLK	2%	2%	0%	2%
XLP	2%	2%	0%	2%

So while XLF was only on the list 3% of 2006 it has been on the list 34% of all 2007 trading days. XLF tracks the S&P 500 financial sector and has been volatile this year because of problems in the mortgage sector. This issue is unrelated to “naked” short selling but its volatility has apparently put it on the threshold list for 34% of 2007.

It appears that Amex updates the total shares outstanding for ETFs daily. You cannot obtain a history of this, but by checking the total shares outstanding daily, on Amex’s website, you can see the changes below for the following days.

Redemption and Creation of Creation Units				
Symbol	April 25, 2007 Share Outstanding (Millions)	April 26, 2007 Shares Outstanding (Millions)	One day Change in Shares	April 26, 2007 SHO Threshold Limit Shares
XLE	68.2	64.4	-3,800,000	322,000
XLY	19.1	18.9	-200,000	94,500
XLF	83.0	83.6	+600,000	418,000
XLB	29.1	26.8	-2,300,000	134,000
XLU	84.4	80.2	-4,200,000	401,000
XLI	34.6	34.6	0	173,000
XLV	56.1	56.1	0	280,500
XLK	85.4	87.4	2,000,000	437,000
XLP	63.3	64.3	1,000,000	321,500
Totals	523.2	516.3	-6,900,000	

¹⁰ This column is through April 27, 2007.

The above table shows that the ETFs are working as expected. If the ETF's price and the price of the underlying component securities diverge traders will Redeem or Issue Creation Units thereby keeping the price of the ETF and its underlying index close to parity. This is a strong reason why ETFs can't be manipulated by "naked" short sellers and should not be subject to the locate and delivery requirements of Regulation SHO. With so many moving parts in ETFs, including daily creation and redemption of shares, I can't see how Regulation SHO is working for these ETFs. An ETF being on the threshold securities list seems to be random and unrelated to potential "naked" short selling market manipulation which the regulations are trying to prevent. The creation and redemption of shares also can dwarf the small threshold securities limits. The above data gives credence to SIA's quote below from their comment letter to the Commission dated September 19, 2006:

"Evidence reveals that a sizeable percentage of threshold securities (especially those from the NYSE and AMEX) consist of such products. SIA believes that these significant percentages may be related to the fact that the calculation of threshold securities does not readily translate to these products, specifically because such calculation presupposes a fixed amount of total shares outstanding (i.e., the aggregate fail-to-deliver must be at least 10,000 shares and equal to at least 0.5% of the total shares outstanding). Unlike issuers of common stock, ETFs do not have such a fixed number of total shares outstanding. Although a fixed amount of ETFs may be delivered by a broker-dealer to a depository for creation, additional ETFs will be created by other market participants on an ongoing basis. Reg SHO's formula does not appropriately take into account this characteristic of ETFs and the appearance of ETFs on the threshold security lists also does not reflect a level of fails that are indicative of chronic delivery problems. Furthermore, from a policy perspective, ETFs do not necessarily present the same concerns with respect to potential manipulative short selling activities, given the fact that the value of ETFs is derived from the market prices of the underlying basket."

The Commission also asks one final question about ETFs in the Amendment to Regulation SHO file number S7-12-06.

"What would be the costs of excepting ETFs or other types of structured products from the definition of threshold securities? Who would bear these costs?"

There should not be much cost to exempting ETFs as Amex, NYSE, and Nasdaq have all requested that ETFs be exempted from being considered threshold securities. The exchanges would just have to program into their systems to exclude ETFs from their daily Regulation SHO threshold securities list. Broker-dealers already use the exchanges threshold securities list to determine which securities are Regulation SHO threshold securities, so it should not affect them. This would not weaken Regulation SHO's major

goal to prevent “naked” short selling market manipulation because as the SIA stated in their September 19, 2006, comment letter to File Number S7-12-06 “SIA firms are unaware of any abusive or manipulative activity which has been linked to fails in ETFs.”

I request the Commission review my findings about ETFs and that the Commission either (i) makes an expressed exception from the locate and delivery requirements of Regulation SHO for transactions in ETFs (ii) or to the extent that the Commission feels the benefits of having these regulations on ETFs outweigh the costs, I urge the Commission to raise the threshold security limit for ETFs from 0.5% to 2.0% of the ETFs total outstanding shares. I feel the definition of an ETF from the Class Relief for Exchange Traded Index Funds File No. TP 07-07 is a good definition for ETFs. If the Commission does not wish to give a blanket exemption it could at least raise the threshold limit on a defined number of ETFs as discussed below.

For example the Commission could either exempt all ETFs that currently have an uptick exemption from rule 10a-1 or raise the threshold limit to 2.0% of the total outstanding shares on all ETFs that currently have an uptick exemption from rule 10a-1.

Alternatively I submit below a proposed definition of an ETF based on the Class Relief for Exchange Traded Index Funds File No. TP 07-07 dated October 24, 2006. ETFs meeting the following criteria could be exempted or granted a revised threshold security limit of 2.0% of the ETF's total shares outstanding, provided that the following conditions are satisfied:

1. The ETF shares are issued by an open-end investment company or unit investment trust registered with the Commission under the Investment Company Act;
2. The ETF consists of a basket of twenty or more Component securities¹¹ with no one Component Security constituting more than 25% of the total value of the ETF¹²;
3. At least 70% of the ETF must be comprised of Component Securities that meet the minimum public float and minimum average daily trading volume thresholds under the "actively-traded securities" definition found in Regulation M for excepted securities provided, however, that if the ETF has 200 or more Component Securities, then 50% of the Component Securities must meet the actively-traded securities thresholds;

¹¹ "Component Securities" are individual securities that comprise the ETF basket, e.g., securities that are assembled to replicate the particular index that the ETF tracks.

¹² Whether any one Component Security constitutes more than 25% of the total value of the ETF shall be determined as of the most recent rebalancing of the ETF's reference securities index.

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4. ETF shares are to be issued and redeemed in Creation Unit aggregations of 50,000 shares or such other amount where the value of a Creation Unit is at least \$1 million at the time of issuance; and

5. The ETF must be managed to track a particular index all of the components of which have publicly available last sale trade information. The intra-day proxy value of the ETF per share and the value of the “benchmark” index must be publicly disseminated by a major market data vendor throughout the trading day.

I also ask that the Commission to in no case, tighten the “grandfather” provision on ETFs, or the “options market maker exception” on ETFs.

I appreciate the opportunity to comment on this proposal and urge the Commission to carefully consider the application of Regulation SHO rules as they relate to ETFs. The Commission should not impose additional requirements in the Rule that could have unintended consequences to ETFs without carefully weighing the cost and benefits of those changes. If the Commission has any questions, please contact me at (713) 253-9546.

Sincerely,

James J. Roth
Tucson, Arizona