

**American Stock Exchange
Boston Options Exchange
Chicago Board Options Exchange
International Securities Exchange
NYSE/Arca
The Options Clearing Corporation
Philadelphia Stock Exchange**

September 22, 2006

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

Re: File No. S7-12-06

Dear Ms. Morris:

The American Stock Exchange, the Boston Options Exchange, the Chicago Board Options Exchange, the International Securities Exchange, the Options Clearing Corporation, NYSE/Arca, and the Philadelphia Stock Exchange (“the Options Exchanges”) appreciate the opportunity to comment on File No. S7-12-06, Amendments to Regulation SHO.¹ In this release, the Securities and Exchange Commission is proposing amendments to Regulation SHO, the Commission’s regulation applicable to short sales. Among other things, the proposed amendments would narrow the options market maker exception in Regulation SHO. Our comments relate primarily to this portion of the proposing release. As currently formulated, we believe that the narrowing of the options market maker exception would significantly harm the ability of options market makers to provide liquidity and narrow quote widths for options when the underlying security is a “threshold security”² without addressing the root cause of the abusive naked

¹ Securities Exchange Act, Release No.54154 (July 14, 2006), 71 Fed. Reg. 41710 (July 21, 2006) (the “Proposing Release”).

² A threshold security is defined in Regulation SHO as any equity security of an issuer that is registered pursuant to section 12 of the Exchange Act or for which the issuer is required to file reports pursuant to section 15(d) of the Exchange Act 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

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short selling. The result would be unnecessary harm to investors and the marketplace.

We understand the enormous pressure on the Commission to target abusive “naked” short selling and to reduce large, persistent fails. However, it is important to remember that short selling serves a legitimate purpose and is not inherently abusive. Stocks are often sold short based on a fundamental analysis because the market views a company as badly managed or severely underperforming. According to the statistics presented in the Proposing Release, Regulation SHO has been extremely effective in reducing fails to deliver on threshold securities.³ We suggest that, rather than proposing changes to Regulation SHO so soon after its effective date that could be harmful to the options markets, the Commission should focus its attention, including enforcement attention, on abusive situations involving naked short selling.

As originally proposed by the Commission, Regulation SHO contained no options market maker exception from the stringent delivery requirements applicable to threshold securities.⁴ The Options Exchanges urged the Commission to include an options market maker exemption from Regulation SHO’s delivery requirements for threshold securities.⁵ The Options Exchanges expressed concern that, without an exemption for options market

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. 17 CFR 242.203(c)(6).

³ For this reason, we oppose the Commission’s suggestion of a mandatory pre-borrow requirement for all firms whenever there are extended fails in a threshold security. The mandatory pre-borrow would replace the current locate requirement. Imposing a pre-borrow requirement on all market participants in the case of extended fails punishes all market participants for the actions of those who caused the extended fail. In addition, it is not clear what impact a pre-borrow requirement would have on market participants who already hold extended fail positions. The market would be better served by Commission action targeted at those who hold extended fail positions. A market participant who complies with Regulation SHO and performs a valid locate prior to a short sale is unlikely to add to the extended fails because he should be able to obtain any shares necessary for delivery. Replacing the locate requirement with a pre-borrow requirement for all market participants would raise costs and increase market inefficiency because a pre-borrow is much more cumbersome and time consuming to arrange than a valid locate. The Commission has failed to articulate the benefits of a pre-borrow requirement and should not impose one.

⁴ Securities Exchange Act, Release No. 48709 (October 28, 2003), 68 Fed. Reg. 62971 (November 3, 2003).

⁵ Comment letter of The American Stock Exchange, Chicago Board Options Exchange, International Securities Exchange, The Options Clearing Corporation, Pacific Exchange and Philadelphia Stock Exchange to the SEC on File No.S7-23-03, at 9. (February 9, 2004).

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makers, Regulation SHO would impair the ability of options market makers to make markets in options on thinly traded securities and increase costs to investors. In response to these comments, and comments from a number of options market makers, the Commission decided to provide an exception from the close out requirements of Regulation SHO to allow registered options market makers to sell short threshold securities in order to hedge options positions, or to adjust such hedges, if the options positions were created prior to the time that the underlying securities became a threshold security.⁶ Based on our experience, the options market maker exception has been effective in permitting options market makers to continue to make markets while limiting abusive fails to deliver.

The Commission now proposes to narrow the options market maker exception to the special delivery requirements for threshold securities in three respects. First, the proposal would limit the exception to the life of the original option positions being hedged. Once that option position is closed out or expires, the fail to deliver in the underlying security must be closed out within 13 settlement days. Second, the proposal would require options market makers to close out a fail to deliver position that hedged an options position that expired or was liquidated on or before the effective date of the new limits on the options market maker exception. These positions would have to be closed out in 35 settlement days after the effective date of the amendment. Third, if a fail to deliver for short sales hedging an options position which is liquidated or expires lasts beyond 13 settlement days or 35 settlement days, whichever is applicable, the options market maker would be required to pre-borrow a threshold security prior to effecting a short sale in that security.

The Commission premises its proposal to narrow the options market maker exception on two factors. First, based on examinations conducted by the Commission's staff and the self-regulatory organizations, the Commission believes that reliance on the options market maker exception is one of the reasons for the continued existence of persistent fails to deliver in a small number of threshold securities.⁷ Second, the Commission sees no reason for

⁶ Securities Exchange Act Release No. 50103 (July 28, 2004), 69 Fed. Reg. 48006 (August 6, 2004) at 48019.

⁷ Proposing Release, at 71 Fed. Reg. 41712.

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an options market maker to maintain a fail position once the options position that it is hedging expires or is liquidated.⁸ For these reasons, the Commission decided to propose a narrowing of the options market maker exception to the special close-out requirements of Regulation SHO for threshold securities. We do not agree that the Commission's stated reasons justify a change to the options market maker exception.

First, persistent fails to deliver tied to options market maker activity are not indicative of abusive intent by options market makers. Options market makers do not effect short selling of securities to engage in speculative or directional trading. Rather, they do so to hedge options positions acquired during the course of market making. Options market makers will buy calls or sell puts in response to customer demand to sell calls or buy puts. The resultant short sale hedges in threshold securities may involve extended fails to deliver, but the driving cause was the customer activity in the options which forced the market makers to sell short to hedge. Naked short selling to hedge by options market makers is not the type of abusive naked short selling that the threshold securities provisions in Regulation SHO are designed to address.

Second, the Commission's view that options market makers have no need of a short position in a threshold security once an options position expires or is liquidated seems to reflect a misunderstanding of how options market makers hedge their positions. 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.⁹ As the risk of those positions moves from one expiration month to another, the options market maker may find it necessary to maintain the short stock position established months earlier.¹⁰

⁸ Proposing Release, at 71 Fed. Reg. 41715.

⁹ The need of options market makers to hedge the overall risk posed by the options positions on their book, rather than a particular options position is recognized by the language of the current options market maker exception in Rule 203(b)(3)(i) which refers to "options positions" when discussing the exception. For this reason, we strongly oppose the proposal to change this language to "an options position."

¹⁰ For example, an options customer whose long put/short call position is expiring may choose to roll that position forward to the next delivery month or even further into the future. Options market makers are often on the other side of customer activity of this type which leads to the establishment of options

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When the options that allow an options market-maker to be exempt from the close-out requirement expire or are closed, investors on the opposite side may roll their long put or short call positions to a new expiration month. Thus, the options market-maker would need to maintain a short position in the stock to be able to accommodate the rolling of positions by investors. As noted above, there is nothing sinister or abusive about this activity; it is a reflection of the options market makers' response to customer demand for options in a particular security. If the Commission takes away the ability of options market makers to effectively hedge, as the proposed narrowing of the options market maker exception would, options market makers will necessarily make wider markets in threshold securities and potentially stop making markets in these securities altogether. This is not merely a theoretical concern. The experience of options market makers since the adoption of Regulation SHO has been that options market maker exception has been critical to their ability to provide liquidity in options overlying threshold securities.

Additionally, the proposed narrowing of the options market maker exception in Regulation SHO is inconsistent with the Commission's net capital rule's provisions with regard to options market makers. Under the 1993 changes to Appendix A of the Commission's net capital rule, options market-makers are penalized severely if their short option positions are not hedged. Those changes encouraged hedging with the underlying stock and fostered a practice among market-makers of such hedging. The proposed amendments to Reg. SHO would impede market-makers' ability to hedge as compelled by the Commission's net capital rule.

Finally, we question whether the perceived benefit of extinguishing persistent fails in a small number of threshold securities will outweigh the costs incurred by more limited or non-existent options trading in these and all current and future threshold securities. As of the date of the issuance of the Proposing Release, approximately 84 of the approximately 300 threshold securities have options traded on them. While this is a very small

positions in forward months that need to be hedged. The hedge for an options position often is a stock position. Risk to the options market maker is lower if he can use a pre-established stock position to hedge the risk of these new options positions. This is especially true if the options market maker established the stock hedge before the stock became a threshold security. If the options market maker knows that he will likely have difficulty hedging his risk, the options market maker will, at the least, widen the bid/ask spread for the options to try to compensate. At worst, he may cease to make a market in the option altogether.

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percentage of all securities that have options traded on them, options on a number of these threshold securities are very actively traded as are the securities themselves. Among the actively traded threshold securities with active options trading are iShares Russell 2000 ETF, Avanir Pharmaceuticals, Krispy Kreme Donuts, Martha Stewart Living Omnimedia, Mittal Steel, Navarre Corp., and Novastar Financial.¹¹

Narrowing the options market maker exception, as proposed, will place options market makers for these and other threshold securities in the position of seriously considering whether to limit or cease to make markets on options on these stocks out of a concern that they will not be able to establish and maintain effective hedges. Without the ability to maintain a consistent hedge, the options market maker may decide that it is not rational to make markets in options on threshold securities. Customers who legitimately wish to take positions in threshold securities may well find themselves unable to do so. The lack of trading in a threshold security will do nothing to address concerns about abusive short selling but will limit the market's ability to express views on the management and prospects of publicly traded companies.

For all these reasons, the Options Exchanges continue to support the current options market maker exception, and urge the Commission to maintain it without any modification. We believe that any benefit of the proposed amendment would be very small compared to the costs to imposed on options market making and the resultant harm to the options customers and the options markets.

¹¹ 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.

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Thank you again for the opportunity to comment on the proposed narrowing of the options market maker exception in Regulation SHO. 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,

The American Stock Exchange
Boston Options Exchange
Chicago Board Options Exchange
International Securities Exchange
NYSE/Arca
The Options Clearing Corporation
Philadelphia Stock Exchange

cc: Erik Sirri
James Brigagliano