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February 6, 2004

S7-23-03

Mr. Jonathan Katz, Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: **Exchange Act Release No. 48709; File No. S7-23-03**

Dear Mr. Katz:

The Pacific Exchange, Inc. ("PCX" or "Exchange") hereby submits its comments to the Securities and Exchange Commission's ("Commission") proposed Regulation SHO and Rules 201, 202 and 203 thereunder ("Proposed Rules"), which concern the regulation of short sales. The PCX wishes to express its views and concerns regarding the Commission's proposal, where such proposals significantly impact Options Market Makers and Specialists ("OMM's").[1] The Exchange believes that the Proposed Rules, as written, will reduce liquidity and widen spreads in the options market and, thus, seriously harm the options market.

Our comments will address two key elements from the Commission's Proposed Rules: 1) the need for an OMM hedging exemption from the proposed uniform bid test in Rule 201 ("Proposed Bid Test"), and 2) the need for an OMM exemption from the proposed additional delivery requirements for short sales in Rule 203(b)(3).

Options Market Maker Hedging Exemption

The Commission is proposing to replace the current price restrictions found in SEC Rule 10a-1[2] (the "Tick Rule") and NASD Rule 3350 (the "NASD Bid Test")[3] with the Proposed Bid Test that would require all short sales in exchange-listed and Nasdaq National Market System ("Nasdaq") securities, wherever traded, to be effected at a price at least one cent above the consolidated best bid at the time of execution. The Commission, however, failed to include a specific OMM hedging exemption, which currently exists in NASD Rule 3350 for Nasdaq securities.

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1 The term Options Market Maker is inclusive of such other terms as Lead Market Maker and any other terms used to refer to a person or entity that performs a market making function in options listed on a national securities exchange.

2 Current SEC Rule 10a-1 does not include an exemption for options market makers for hedging transactions of OMM's in exchange-listed securities. The Exchange has proposed that the Commission establish an exemption to SEC Rule 10a-1 for hedging transactions of options market makers, similar to the exemption currently in place under NASD Rule 3350. See Letter from Robert M. Greber, Chairman, Pacific Exchange, Inc., to Richard R. Lindsey, Director of Division of Market Regulation, Securities and Exchange Commission (March 3, 1998).

3 Current NASD Rule 3350 includes an OMM exemption for hedging transactions.

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The Exchange strongly urges the Commission to modify its Proposed Bid Test to include a hedging exemption for OMM's, when selling stock short, to hedge the risk of exposure of options positions in any options class obtained in the course of performing market-making functions.[4] Such an exemption is crucial for OMM's to provide liquidity and depth to the market for listed options by affording them the opportunity to hedge their risk in a meaningful way, without regard to restrictions that were designed to prevent manipulative transactions.

While the Commission's objective for the Proposed Bid Test is well founded, the PCX believes a limited exemption for OMM's seeking to hedge positions acquired in connection to their market-making functions will not hinder the Commission from accomplishing its goal. An exemption from the Proposed Bid Test is crucial for OMM's, based on the fact that it is essential for OMM's to maintain options positions that are hedged with the underlying stock. This is necessary to reduce the risk for the OMM's, in particular, and the options market place, in general. An OMM can significantly reduce the risk of long call and/or short put positions by selling stock; and, likewise, an OMM can reduce the risk of short call and/or long put position by buying stock. Hence, such an exemption is necessary for an OMM to make markets. Absent such an exemption, the options market will be seriously harmed, since OMM's will be unable to properly provide liquidity and narrow markets.

In addition, it is important to note that OMM's have numerous market maker obligations imposed by the Commission and the options exchanges. For example, OMM's are generally required to maintain a fair and orderly market and, as necessary, engage in dealing for their own accounts to foster price continuity, and balance the supply and demand for a particular option contract. Given the magnitude of obligations bestowed upon OMM's, it is important that OMM's are able to effect short sales to hedge their risk without being constrained by price restrictions, so they can properly fulfill such obligations and properly make markets.

The Exchange also believes that the OMM hedging exemption currently provided in NASD Rule 3350 is indicative that an OMM hedging exemption to the Proposed Bid Test can be applied without abuse to the short sale rule. The Commission previously approved NASD Rule 3350, which includes an exemption for OMM's from short sale transactions 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 good faith margin pursuant to Section 220.12 of Regulation T under the Act for that transaction."[5] NASD Rule 3350 further provides that such an exemption is limited to "qualified options market makers" at a "qualified options exchange".

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4 The Exchange urges the Commission to refrain from excluding the OMM hedging exemption from the Proposed Bid Test, even if it is only for a pilot experiment. The complexity and changes to the OMM firm's systems to accommodate such a pilot is tremendously significant.

5 <u>See</u> NASD Rule 3350(h).

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The Commission, itself, noted that such a limited exemption would not counter the effectiveness of the NASD's short sale rule. The Commission also noted that such an exemption is for legitimate hedging transactions by OMM's would minimize the potential adverse impacts on the options markets.[6] Hence, the Commission clearly recognized the importance of such an exemption for OMM's as a necessity for the options market. Given that this limited exemption has not resulted in any significant cause for concern in the ten years that it has been in place, we see no reason why the Commission should abolish the exemption now.

The Exchange does not oppose the Commission contemplating the Proposed Bid Test given the significant developments in the securities markets. However, we believe that the OMM hedging exemption in NASD Rule 3350 has served to increase depth and liquidity in the options market, reduce the risk to OMM's in assuming options positions, and to foster better executions for the public and other investors without increasing the risks that the short sale rule was designed to prevent. We strongly believe that such an exemption is a necessity for an OMM to fulfill its market making obligations in the options market and continue to provide liquidity and continuity to the market. Accordingly, the Exchange urges the Commission to include a specific OMM exemption for hedging transactions from the Proposed Bid Test.

Proposed Delivery Requirement

The Commission, in its Proposed Rule 203(b)(3), seeks to impose stringent delivery requirements on securities that have fails at a registered clearing agency of 10,000 shares or more and that are equal to at least one half of 1 percent of an issue's total shares outstanding. It also specifies that, for short sales of any security meeting this threshold, the selling broker-dealer must deliver the security no later than two days after the settlement date. If the security is not delivered within this time, the broker-dealer, including market makers, is restricted from executing further short sales in the security for the account of the person for whose account the failure to deliver occurred (including the broker-dealer's own account in the case of a proprietary short sale) for 90 days, unless the broker-dealer has borrowed the security, or entered into a bona fide arrangement to borrow the security, prior to executing the short sale, and will deliver the security on the date delivery is due. In addition, the proposed rule requires the registered clearing agency processing the transaction to (a) refer the broker-dealer failing to deliver such securities to the NASD and the designated examining authority for appropriate action; and (b) withhold a benefit equal to any mark to market amounts or payments that otherwise would be made to the party failing to deliver, and take other appropriate action as necessary. The proposed rule does not provide for an OMM exemption.

The Exchange strongly urges the Commission to include an exemption for OMM's from the delivery requirements as proposed in Rule 203(b)(3). This proposed rule derives from current NASD Rule 11830, which includes an exemption for OMM's for bona fide market making transactions.

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6 See Securities Exchange Act Release No. 34277, 50 FR 34885 (July 7, 1994).

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The Commission did not propose an exemption from the delivery requirements for short sales for market makers, because the Commission believes that "extended failures to deliver appear characteristic of an investment or trading strategy, rather than being related to market making." The Commission, however, did not provide any information as to how "options" market makers are responsible for significant failure to deliver. It is highly unlikely that OMM's would engage in non-hedge stock activity due to numerous regulatory ramifications. In other words, the Commission failed to distinguish a stock market maker from an OMM and the fact that it is crucial for OMM's to be exempted from the delivery requirement when selling stock short to hedge legitimate market making functions.

Absent an exemption from the delivery requirements for OMM's, we believe that Proposed Rule 203(b)(3) will make it essentially impossible for OMM's to fulfill their obligations and will completely disrupt the options market. OMM's will likely be restricted by their clearing firms from trading hard-to-borrow securities, which will make it impossible to hedge exposure arising from their market making activities. As a result, OMM's ability to provide liquidity to the market place will be decreased. Such an effect will impair the OMM's to make markets and eventually increase costs to investors. Thus, the PCX respectfully request that the Commission reconsider its proposed rule and provide an exemption for the OMM's from the delivery requirements.

The PCX appreciates the Commission's consideration of its comments on the Proposed Rules. We would be happy to provide any other information that the Commission may require. Please feel free to contact us with any questions.

Sincerely,

Philip D. DeFeo
Chairman and Chief Executive Officer

PDD/AA:esy

cc: The Honorable William H. Donaldson
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The Honorable Roel C. Campos
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