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OFFICE OF THE SECRETARY

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: Short Sales (File No. S7-23-03)

Dear Mr. Katz:

I am writing on behalf of Susquehanna International Group, LLP and its affiliates ("SIG") to comment on the proposed rule change ("the Proposal") by the Securities and Exchange Commission ("Commission") to modify the short sale rules.[1] SIG believes that the Commission's efforts in this regard are timely and generally well directed, but certain safeguards should be maintained to ensure necessary liquidity levels by stock and options market makers.

Of particular concern is the potential absence of market maker exemptions from the locate and delivery requirements regarding (i) the mandatory buy-in[2] rules and (ii) heightened delivery requirements for securities exceeding a predefined limit of settlement failures ("limit-fails") as set forth in proposed Rule 203. While these provisions, coupled with the proposed imposition of a 90-day short sale freeze ("penalty freeze"), would as expected drastically reduce market maker activity in limit-fail securities, they would also drain liquidity levels in a great many other securities -- including securities where there is no current indication of significant settlement failures.

If these provisions are implemented, market makers would need to assess for each assigned security the probability of its becoming a limit-fail security in the future. For each security where this is thought a realistic possibility, the market maker would need to decide whether to incorporate the added risks into pricing or relinquish market maker status in that security. This decision would need

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1 Proposed Regulation SHO would replace current Rules 3b-3, 10a-1 and 10a-2. Exchange Act Release No. 48,709 (Oct. 29, 2003), 68 Fed. Reg. 62,972 (Nov. 6, 2003) ("the Proposal").

2 Although not included in the Proposal, the Staff advised us that the Commission may propose short term mandatory buy-in procedures where there is evidence of significant settlement failures. As comments were not solicited for this proposal, we urge the Commission to provide interested parties adequate time to analyze and comment on any such proposal.

to be made before the market maker's position becomes very large, which would cause a reduction in liquidity for such securities long before the requisite amount of fails were to trigger the subject buy-in and delivery provisions. The probable amount of limit-fail securities that would result in mandatory buy-ins or penalty freezes, or both, would create enormous monetary risk to market makers. The Commission should carefully review the impact that adopting these steps would have on market maker participation.

The adverse impact on liquidity would be particularly acute for options market makers. Options market makers must be able to hedge their risk by buying and selling the underlying stock when they facilitate options orders. And they must fill incoming options orders because of their affirmative market making obligations. Consequently, options market makers necessarily maintain large short hedging positions in underlying stocks for extended periods of time. Short hedging positions are not maintained for speculative or abusive purposes; to the contrary, they offset risk to thereby enable the market maker to continue facilitating more incoming option orders. In addition, options market makers routinely need to adjust hedges dynamically, as overall risk changes occur through a variety of market factors (such as additional option purchases and sales, changes in the price or volatility of the underlying stock, the passage of time, etc). The absence of exemptions from these provisions for options market makers will have a chilling effect on their willingness to commit capital to the markets. This substantial risk will be reflected in reduced liquidity and efficiency in the marketplace, which will result in additional costs to the public. It could also prompt a departure of market makers in significant numbers.

While we believe that bona fide market making activity should be absolutely exempt from the mandatory buy-in and the heightened delivery requirement and penalty freeze proposals[3], the implementation of any such provision should, at a minimum, exempt market maker positions that are acquired prior to the effective date of the rule and should likewise exempt any position that is acquired prior to the subject security being triggered as a limit-fail. The aforementioned loss of liquidity would be significant and immediate if these provisions were to be applied retroactively to positions acquired prior to effectiveness. We urge the Commission to not withdraw these exemptions or impose a penalty freeze provision. In any event, however, the Commission should not make these mandatory buy-in and limit-fail provisions applicable to any market maker positions pre-existing on the effective dates.

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[3] In the Proposal, the Staff indicates that no exemption is needed for market making because "it is questionable whether a market maker carrying a short position in a heavily shorted security for an extended period of time is in fact engaged in providing liquidity for customers, or rather is engaged in a speculative trading strategy." Inherent in this statement is a recognition that an exemption would be warranted if it was needed to promote bona fide market making, but no exemption is needed because bona fide market making will not be inhibited by this restriction. We think it is very dangerous for the Commission to make these presumptions when engaging in rule making. Instead, the Commission should determine whether it wishes to promote the desired activity (i.e., bona fide market making) by granting an exemption and then determine how best to surveil to assure that others (e.g., those engaged in speculative trading strategies) do not mistakenly or inappropriately rely upon the exemption.

By way of background, SIG functions predominantly as an options and stock market maker/specialist, as well as an upstairs broker and facilitator of institutional order flow. We know from experience that the primary challenge to market making is to provide two-sided liquidity in the face of significant one-sided order flow. The risks of meeting this challenge are already substantial, but are exacerbated in today's markets as market maker quotes are prone to more informed buyers and sellers and often fall prey to market "takers" with sophisticated electronic systems that can, in a split second, exploit a quote change in exchange quoting systems. These risks are particularly high in the options market where relatively greater leverage is employed and off-floor systems are able to send computer generated orders before market maker systems are able to change bundles of quotes.

Recognizing the important contributions of market makers and the above-mentioned risks, the current short sale rules allow options market makers a measure of ability to hedge and cover these risks. This ability helps achieve an acceptable balance between the aforementioned risks and the desire to act as an options market maker. The trade-off has always been that if market makers know they have a reasonable ability under adverse circumstances to cover potential losses through hedges and offsets, they will be more apt to accept the risks and maintain deep and liquid two-sided quotes. The current proposals would, however, upset this balance.

Options market makers have historically assumed the frequent risks of inadequate hedging opportunities in the underlying stocks. But they have never had to factor in a complete inability to hedge with stock, as they would if the exemptions are withdrawn. This complete inability for market makers to hedge would naturally result in a reluctance to engage in market making in many stocks. Nor have options market makers been forced to provide liquidity without the ability to hedge due to the imposition of a "freeze period". Absent appropriate relief from the mandatory buy-in and penalty freeze proposals, liquidity in the options market will be severely dampened at all times in a broad range of securities.

In addition to the above, we believe the Proposal should be modified, as follows:

1) **300 Stock Pilot.** The 300 stock pilot, if implemented at all, should be drastically reduced to a handful of stocks. The short sale rule has protected the markets for over 70 years; radically changing it for a significant number of stocks does not appear worth the risk of withdrawing important safeguards. The cost savings may be significant if the effects on the pilot stocks can be analyzed before any changes to less liquid stocks are attempted. Some of the otherwise difficult systems changes may be avoided entirely by what we learn from the pilot. There is a saying that good judgment comes from experience and experience comes from bad judgment. We should first learn what we can from our experience with the pilot.

2) **Bid Test Market Maker Exemptions.** We recommend that the market maker exemption currently contained in NASD Rule 3350 be made available to all stock and option market makers in all listed and NMS issues. If the Commission wishes

to add specific parameters to the definition of *bona fide* market making and distinguish it for short sale purposes, we recommend that the new parameters include any instance where a registered market maker in the stock or option is attempting to trade the same or a related hedge security in connection with the facilitation of a customer order either in its possession or recently facilitated. These parameters should also specify that bona fide market making includes hedging trades of any position assumed in connection with an affirmative market making obligation.

Although options market makers need to offset risk by hedging in order to fulfill their market making obligations, the Proposal's bid test would dramatically lessen the ability to effect hedges with short sales in underlying stocks. It is explained in the Proposal that a hedging exemption for short sales was not included based upon the belief that the proposed bid test and pilot program will provide sufficient additional flexibility to effect hedging short sales. Although it is possible that this presumption is correct in relation to the pilot stocks, it is falsely presumed in relation to the new bid test for other covered stocks. Since the Proposal would not allow an options market maker to hedge the risk of market making positions by selling short to a bid at any price, the Proposal creates an enormous challenge to the pricing of options. Indeed, the inability to offset risk by hitting bids would necessarily result in such risk being reflected in options premiums themselves. This would increase option quote spreads and curtail liquidity in the options market.

3) **The Locate Rule – Principal Trades.** The proposal would allow a broker-dealer to execute a short sale order for its own account if it has reasonable grounds to believe that it can meet settlement date delivery. As the Commission is soliciting comments on what should constitute "reasonable grounds," we recommend that "easy-to-borrow lists" continue to be an acceptable method. Locate problems seldom develop in issues on easy-to-borrow lists.

4) **The Locate Rule - Customer Orders.** Meeting the standard for Best Execution of customer orders requires that orders be processed and placed without undue delay. Firms need to rely on customer assurances in this regard. To do otherwise would be to delay all orders for the sake of problems attributable to a very few. Broker-dealers should be allowed to accept a customer's assurance of ownership or that a locate has been secured. Quite often, the fail is attributable to an error or delivery delay that corrects within a few days after the settlement date. If the same customer has developed a track record of fails, it would be appropriate to institute more strict criteria for that customer. But the notion of a 90 day freeze, as suggested, is unrealistic and unmanageable, especially for market makers with affirmative market making obligations.

5) **The Locate Rule – Market Makers.** We agree with the Proposal that a locate exception for market makers and specialists engaged in bona fide market making activities is necessary. As discussed above, however, the bona fide market making exemptions should also extend to the proposed "additional delivery requirements" and any mandatory buy-in provision.

6) **Bid Test for Regular Session Only.** The bid test should not be imposed on any trades effected outside the Regular Session (i.e., 9:30 am to 4:00 pm). Trades effected outside normal business hours are predominantly institutional and professional. The bid test for NASDAQ issues is currently a Regular Session rule that has proven effective in protecting against short sale abuses while permitting legitimate after-hours facilitation, hedging and unwinding trades to occur away from retail order flow. Imposing this rule outside of the Regular Session gains little in terms of protections but loses much in terms of market efficiency and flexibility.

7) **Bid Test for U.S. Reported Trades Only.** The Commission should not seek to impose the bid test rule on foreign trades in U.S. securities. U.S. entities that trade U.S. securities overseas are predominantly institutional and professional. Trading interest that originates in the U.S. and is sent overseas is of minimal impact to pricing in the U.S. markets. If there is a concern for away trades, the Commission may instead wish to address how legitimate hedging and facilitation trades currently effected overseas can instead be accommodated in the U.S.

8) **Domestic Arbitrage.** Expanding the domestic arbitrage exception to require that the short seller must subsequently acquire or purchase the arbitraged security will diminish the value that domestic arbitrage now provides to the market without introducing any new pertinent contributions to market efficiency. The fact that arbitrage narrows the quotes should be encouraged, but making arbitrages contingent on conversion and delivery makes arbitraging considerably more expensive and therefore will deprive the market of liquidity.

9) **Volume Weighted Average Price.** While we applaud the effort to codify prior VWAP exemption letters into Regulation SHO, we believe that the proposal needlessly limits the use of VWAPs by market participants. Specifically, instead of limiting the exemption to all-day VWAPs, the proposal should recognize the tremendous value that VWAPs provide to lessening market impact of intra-day institutional orders and make the exemption applicable to any VWAP *where the market value of the order exceeds $1 million and the VWAP period is at least 30 minutes.*

While all VWAP executions should be generally at the VWAP price, minor algorithm-adjustments should be allowed on the fill price from the executing facilitator to allow net pricing as a commission equivalent. VWAP orders have already become a significant order-type in the markets and a vital method for many

> portfolio managers to manage intra-day volatility risks. Facilitating such orders should be encouraged; the present Proposal will instead serve to discourage their use.

The short sale rules have served to protect market participants over the years from many forms of short sale abuse. The need for short sale protections grow as liquidity demands grow. Hedging facilitators and market makers have met these liquidity demands by developing more sophisticated hedging techniques that manage long and short side trading on a market neutral basis. The Proposal, as contemplated, will stymie rather than stimulate liquidity growth by discouraging market makers to continue as liquidity providers. We encourage the Commission to explore how it can achieve the goal of short sale protections without casting aside the many important hedging strategies employed by market makers.

Thank you for this opportunity to respond.

Sincerely,

Gerald D. O'Connell
Compliance Director

cc: Chairman William H. Donaldson
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Ms. Annette L. Nazareth, Director, Division of Market Regulation
Mr. Robert L.D. Colby, Deputy Director, Division of Market Regulation