CHADBOURNE
& PARKE LLP

30 Rockefeller Plaza, New York, NY 10112
tel 212-408-5100 fax 212-541-5369

September 13, 2007

The Honorable Christopher Cox, Chairman
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
The Honorable Annette L. Nazareth, Commissioner
The Honorable, Kathleen L. Casey, Commissioner
United States Securities and Exchange Commission
100 F Street, NE
Washington D.C. 20549-0609

Re: Securities Exchange Act Release No. 56213; File No. S7-19-07

Dear Chairman Cox and Commissioners:

We respectfully submit this comment letter in response to the above release on behalf of UBS Securities LLC, the U.S. investment banking arm of UBS AG ("UBS").[1] UBS opposes the Securities and Exchange Commission ("Commission") proposed amendments to Regulation SHO. In particular, UBS opposes the proposal to require brokers-dealers marking a sale as "long" to document the present location of the securities being sold. UBS also opposes the proposed amendment eliminating or otherwise limiting the options market maker exception to Regulation SHO buy-in requirements. UBS believes that the proposed amendments are unnecessary, redundant to existing regulation, unduly burdensome, and inefficient, and the cost of implementation and ongoing compliance will greatly outweigh any potential benefit arising from these proposed amendments.

[1] UBS AG is one of the largest financial institutions in the world serving a diverse customer base ranging from affluent individuals to multinational institutions and corporations. The firm has 87 stock exchange memberships in 31 countries, and is widely acknowledged as a leader in the secondary equity trading markets. In the U.S., the firm is active in all of the equity, fixed income and option markets. It is one of the largest traders of equity securities on the NYSE and NASDAQ markets. UBS Investment Bank is a business group of UBS AG. UBS Securities LLC is a subsidiary of UBS AG.

INTRODUCTION

Regulation SHO, adopted under the Securities Exchange Act of 1934, became effective January 3, 2005.[2] The Regulation sets forth the regulatory framework governing short sales, targeting, in particular, potentially abusive "naked" short selling. The Regulation is intended to address those situations where the level of fails to deliver for a particular security is so substantial that it might negatively impact the market for that security. Among other things, Regulation SHO imposes a mandatory close-out requirement to address those failures to deliver.

As originally adopted, Regulation SHO contained exceptions from the mandatory close-out requirements for grandfathered securities and for hedge positions established by options market makers. On July 14, 2006, the Commission published proposed amendments to Regulation SHO eliminating the grandfather exception and narrowing the options market maker exception.[3] The proposal was based, in large part, on the results of examinations conducted by the Commission's staff and the SROs after adoption of Regulation SHO, as well as the Commission's perception of the persistence of open fails to deliver in certain "threshold" securities.[4]

On June 13, 2007, the Commission approved the adoption of the amendment eliminating the grandfather exception.[5] In response to various comment letters, however, the Commission determined not to adopt the proposed changes to the options market maker exception. Instead, the Commission re-proposed amendments to Regulation SHO.[6] (the "Proposing Release") The Commission stated that the re-proposed amendments were intended to further reduce the number of persistent fails to deliver in certain "threshold" securities by entirely eliminating the options market maker exception. In the alternative, the Commission requested comment regarding two alternatives limiting the options market maker exception. The Commission also proposed an amendment to the long sale marking provisions of Regulation SHO requiring brokers and dealers marking a sale as "long" to document the present location of the securities being sold. The Commission now seeks comment on these proposals.

---

[2] 17 CFR 242.200. *See,* Securities Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (Aug. 6, 2004).
[3] Securities Exchange Act Release No. 54154 (July 14, 2006), 71 FR 41710 (July 21, 2006). UBS submitted a comment letter on this earlier proposal. *See*, Letter from Gerard S. Citera, Executive Director, U.S. Equities, UBS Securities LLC, dated September 22, 2006.
[4] *Id*.
[5] Securities Exchange Act Release No. 56212 (August 7, 2007), 72 FR 45544 (August 14, 2007).
[6] Securities Exchange Act Release No. 56213 (August 7, 2007); 72 FR 45558 (August 14, 2007).

DISCUSSION

A. The Long Sale Marking Requirement Should Not be Adopted

The Commission proposes a requirement that broker-dealers executing sell "long" orders document the present location of the securities being sold. UBS is strongly opposed to this requirement as unnecessary, redundant to existing regulation, unduly burdensome, inefficient and costly to implement. In essence, this proposal would require revamping front-end order management, trading, and record retention systems necessary to capture and store this information. It would also impose substantial ongoing costs on the industry. Since firms have already established procedures pursuant to Regulation SHO to assure that trades are appropriately marked long, there is no valid purpose for this requirement.

1. The Long Sale Marking Requirement is Not Necessary.

There is no evidence that the long sale marking requirement is being abused to effect short sales in violation of the affirmative determination requirements. While the Commission points to persistent outstanding open fail positions, it does not provide any evidence that these positions resulted from the mis-marking of long sales. Moreover, fails to deliver make up a small percentage of all transactions. In footnote 5 of the Proposing Release, the Commission itself notes that " 99% (by dollar value) of all trades settle on time [and the] vast majority of these fails are closed out within five days after T+3". Thus, the long sale marking requirement will not further the goals of Regulation SHO since it will not significantly decrease the amount of outstanding naked short positions in the market.

2. The Long Sale Marking Requirement is Redundant to Existing Regulation.

The "Fail On Sale" process already required by Regulation SHO has been effective in identifying customers who abuse the long marking requirements. Broker-dealers are currently required to monitor the reasonableness of customers marking their orders sell long. Most firms have set up tracking mechanisms and review procedures to evaluate fails to deliver to detect potentially abusive behavior. UBS, for example, has established an FOS Committee that reviews all accounts with more than a minimal number of customer fails to deliver in a one month period and determines whether there is a reasonable reliance on the customer long sale designation. The Committee analyzes the cause of the fail to deliver, whether the fail is in a hard to borrow or threshold security, and how the fail to deliver is closed out. The Committee tracks these fails to deliver on a month to month basis to detect individual examples of abuse or patterns of abuse over time. If it discovers that a customer is not "reliable" it will speak to that customer, monitor the customer's activities more closely, put the customer on a watch or restricted list, and/or take further action as necessary including restricting trading or closing the account if a pattern of abuse continues.

Requiring an affirmative marking of where the security is held will in no way assist or enhance this review process. The customer is already required to certify that it holds the securities long when it gives instructions to sell a security long. The long nature of the transaction is duly noted on the order ticket and captured in the firm's record keeping systems. Many firms have account documentation or other agreements with customers that expressly impose this obligation on the customer. In the case of a customer acting in good faith, the additional documentation requirement will add nothing to the surveillance program. Further, if a customer purposely misrepresents the long status of the security, he will also likely be willing to fabricate the location of the securities when questioned. Since there is limited ability to check inter-company to determine if the customer is giving true information, nothing would be added to the surveillance process. Whether or not the customer gave a valid location for the securities, the fail to deliver will show up in the FOS process and the firm will still take appropriate action.

The requirement will be virtually impossible to automate at institutional trading firms. In retail firms, where the majority of the accounts are custodial accounts, there may be a method of automating the check against the positions in an account to assure ownership of the stock before sale. Even in this situation, however, a large number of false positives will occur, for example when the customer holds the securities long at another firm, in another account at the same firm, or in physical certificates. In addition, the cost of implementing this automated check would be substantial. Hypothecation of margin securities may also cause significant issues at retail custody firms. If the securities are re-hypothecated by the firm, the customer may believe it is long for sales purposes even though the securities are not immediately available for delivery.

On the other hand, at institutional firms that trade primarily delivery vs. payment ("DVP"), the securities will rarely, if ever, be held at the firm. Only in the situation where the executing firm is also the prime broker for the seller, would the firm have direct custody of the securities. Even in this situation, however, the prime broker systems are not usually connected to the execution systems, and the system build to connect the processes would be difficult to implement. It is currently not possible to establish links to custodial firms or third party prime brokers to automatically check the location of securities.

In the short sale arena, the requirement is to document that you will be able to borrow the securities to deliver, which can be automated in part through the use of an easy to borrow list. The determination is not specific to the particular location of the security being sold but instead to whether the firm will be able to borrow the securities to deliver. However, the proposed long sale location requirements are specific to the location of the securities being sold and therefore must be done on a trade-by-trade basis.

3. The Long Sale Marking Requirement Will Add Substantial Inefficiencies to Automated Trading Markets.

Today, many trades are executed in the market place electronically without human interface: direct market access programs, front end trading platforms delivered directly to customers, algorithmic trading systems, and on-line trading accounts for individual clients are all examples of this trend. As a result, substantial modifications to front end systems would be required to capture, verify and convey the long sale locate information on every long sale. The end result would be that the broker-dealer would still have to rely on the veracity of the customer to provide the location of the securities. Again, this adds nothing to the current requirement that the customer certify that he owns the security when he places a long sale order. In situations where the information was not provided by the customer, the trades would have to be removed from the automated system and processed manually to obtain the information. This clearly undercuts the benefits of automated trading without any corresponding benefit to enforcement of Regulation SHO.

4. The Cost of the Long Sale Marking Requirement Greatly Outweighs any Potential Benefit.

The costs of implementation, ongoing compliance, surveillance and enforcement of the new marking requirements greatly outweigh any incremental benefit of the proposed amendments.

The Commission significantly underestimates the cost of compliance with the new requirement by estimating the time necessary for compliance on a trade by trade basis will be .5 seconds per trade. This severely understates the amount of time firms will have to spend dealing with this requirement. This is particularly true at institutional firms that do not custody the securities, since the process cannot be automated. Each trade will require a conversation with the customer and a physical marking of the order ticket, which could take multiple seconds to accomplish. This does not even take into consideration the situations where problems arise with respect to automated trades which do not contain the proper information, or where the information provided by the customer is not complete or accurate. Based on the Commission's estimate that the new rule will affect over 2 billion trades per year, the incremental cost of even a small increase in time could be significant. Even at the Commission's estimate of .5 seconds per trade, the annual hourly burden on the industry would be 268,688 hours. If the time merely doubles to 1 second per trade, the annual burden would be well over 530,000 hours.

The Commission also severely underestimates the cost of implementation of the proposed changes, estimating an average cost of $1072 per firm. This is based on an estimate of only 16 hours of programming at $67 per hour, per firm. The Commission ignores the fact that essentially every front end order capture, order management, trade processing, record keeping and trading system will have to be modified to capture and store this information. When

Regulation SHO was first implemented, UBS embarked on a complete review and revision of its front end-trading systems to assure that the proper information was captured, evaluated and stored in connection with the affirmative determination requirements of the rule relating to short sales. While this involved a substantially smaller subset of trades, the project took over one year to complete and involved substantial involvement from the legal, compliance, regulatory control, operations and IT departments of the firm. Virtually every front end system was affected to some extent and the order flow in those systems had to be redesigned to assure proper checks and balances. While UBS did not separately capture the exact cost of that process, it easily exceeded hundreds of thousands of dollars in actual expenses as well as employee time. The cost and difficulty of implementation of the long sale marking requirement would be even greater, since, as noted above, it cannot be automated with an easy to borrow process and involves substantially more trades.

Finally, the Commission underestimates the cost of continuing surveillance, supervision, compliance, record keeping and enforcement caused by the new rule. Firms will have to establish supervisory review and surveillance programs which will cost money to implement and maintain. As noted above, this would be redundant to the FOS process which has already been established in most firms and has proven effective in demonstrating compliance with the long marking requirement.

5. Proposed Exception for Institutional Trading Firms and/or for DVP Trading Activity.

In the alternative, there should be an exception for institutional trading firms that do not generally custody securities for customers. The difficulty in automating the process for these firms and the inherent reliance on the veracity of clients would make those procedures ineffective. Enhanced surveillance at those firms and the FOS process discussed above should be sufficient to detect potential abuses of the long sale marking requirement through tracking of fails to deliver.

At the very least there should be an exception for prime broker and DVP trading where settlement instructions are on file with the executing firm. Ultimately, broker-dealers will have to rely on the word of the customer about whether he is long and the location of the securities. There are no electronic connections to custodian banks or to prime brokers to confirm customer statements. Of particular significance, this exception was previously included in the NASD rule on this issue to recognize the unique nature of this trading activity, and therefore should be reincorporated in the Regulation SHO requirements.

B. Proposal to Repeal or Limit the Options Market Maker Exception

The Proposing Release would also eliminate the exception from the mandatory close-out requirements that currently applies to hedge positions established by options market makers. The Commission seeks comment on two alternative proposals that would retain the options market maker exception but limit its scope. Alternative 1 would require closing out existing fail to deliver positions arising from the options market maker exception within 35 days of a stock hitting the threshold list, and closing out all new fail to deliver positions within 13 days thereafter. Alternative 2 would require closing out existing fail positions arising from the options market maker exception within 35 days of stock hitting the threshold list or 13 days after all series of the option expire or the option positions are liquidated by the market maker, and closing out all new fail to deliver positions within 13 days thereafter.

1. The Options Market Maker Exception should be Maintained.

UBS opposes the proposed changes and believes that the options market maker exception has continuing value. Options market makers provide valuable liquidity to the options markets, relying in large part on the ability to hedge their corresponding risk in the equity markets. They stand ready to buy and sell a broad range of option classes and series. More importantly, market makers have affirmative obligations to maintain active quotes in a certain amount of options series for certain periods of time. Failure to meet these minimum quotation requirements could lead to significant penalties by the various options exchanges. More importantly, options market makers do not have the choice of trading or not trading with orders that are routed to them, but instead must meet firm quote obligations and execute at their quotes.

In order to manage this risk, market makers must be free to hedge their option positions in the equity trading markets. Without such hedging opportunities, market makers would not be able to provide the same level of trading support. Market makers would possibly choose to exit the market for particular options classes rather than be put in the situation of having to close out existing hedge positions or establish costly borrows against those positions, particularly in markets where borrowing the security might be difficult or impossible to effect. On the fringes, certain firms may determine not to be a market maker in any options. This would have a negative impact on cost of hedging, liquidity, depth of the market and spreads in the option markets. If these results are realized, the cost of this new rule would greatly outweigh any potential benefits to the market.

One question asked by the Commission in the Proposing Release was whether this exception gives option market makers an unfair advantage because it treats them differently than market makers in the equity securities. This misstates the nature of the exception, since the options market makers are treated the same as market makers in the stock having a similar exemption from Regulation SHO buy-in requirements.

A second question posed by the Commission in the Proposing Release is whether the corresponding exception to the affirmative determination requirements for options market makers should similarly be repealed. The answer to this question is definitively "no." The exception to the affirmative determination requirement is absolutely necessary for option market makers to function in the market. If, prior to execution of a hedge position, the market maker would have to obtain an affirmative determination that it could borrow the securities, it could not respond promptly to the orders routed to it for handling. In some cases, if the borrow was not available, it could not execute the hedge trade at all. This would severely undercut the ability to act as a market maker, particularly in the electronic trading markets that exist today. The effect would be particularly significant in the less liquid securities where market maker participation in both the equity and options securities is most valuable.

2. If the Commission Determines that a Change is Necessary, UBS would support the More Targeted Approach in Commission Alternative 1.

In the event that the Commission determines that it is necessary to limit the options market maker exception, UBS would support a more targeted limitation, preferably Commission Alternative 1, as discussed above. While this proposal would limit the market maker exception somewhat, it would provide a reasonable amount of additional time to close out the relevant stock positions after the stock was placed on the threshold list. Thus, its negative impact on option market makers would be lessened. Commission Alternative 2 above, while giving similar flexibility, is less desirable since it will be much more complicated and difficult to program, implement and monitor, with very little additional protection. As noted in the Proposing Release, the rule would be difficult to implement in light of portfolio management strategies currently used to hedge risk.

CONCLUSION

Based on the above arguments, UBS respectfully requests the Commission to reject the proposed amendments to Regulation SHO. In the alternative, UBS requests that the Commission adopt the more limited change to the option market maker exception discussed above.

Thank you for your consideration of this letter. If you have any questions or would like any further information regarding the issues raised in this letter, please call the undersigned at (212) 408-5176.

Sincerely,

Gerard S. Citera, Esq.

CC:
Nancy M. Morris, Secretary, Securities and Exchange Commission
Eric Sirri, Director, Division of Market Regulation, Securities and Exchange Commission
Robert Colby, Deputy Director, Division of Market Regulation, Securities and Exchange Commission
James A. Brigagliano, Associate Director, Division of Market Regulation, Securities and Exchange Commission
Josephine J. Tao, Assistant Director, Division of Market Regulation, Securities and Exchange Commission
Victoria L. Crane, Branch Chief, Division of Market Regulation, Securities and Exchange Commission
Elizabeth A. Sandoe, Branch Chief, Office Division of Market Regulation, Securities and Exchange Commission,
Lillian Hagen, Special Counsel, Division of Market Regulation, Securities and Exchange Commission
Joan M. Collopy, Special Counsel, Division of Market Regulation, Securities and Exchange Commission