

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

September 19, 2007

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

Re: File No. S7-19-07

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. S7-19-07, 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. The Commission proposes elimination of the options market maker exception to the close out requirements for threshold securities in Regulation SHO. The Commission also proposes two alternatives to the current options market maker exception. Finally, the Commission proposes requiring that broker-dealers marking orders as “long” sales document the present location of the securities.

We oppose the Commission’s proposal to eliminate the options market maker exception because we are concerned that this would significantly

¹ Securities Exchange Act, Release No. 56213 (August 7, 2007), 72 Fed. Reg. 45558 (August 14, 2007) (the “Proposing Release”).

Ms, Nancy Morris
September 19, 2007
Page 2 of 6

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 As we have asserted in the past,³ we are convinced that the result of eliminating the options market maker exception in Regulation SHO is likely to be more limited or non-existent options market maker liquidity in current and future threshold securities. This is the case because options market makers are likely to be very reluctant to make markets on options on threshold securities or those that could become threshold securities if they cannot be certain that they will be able to establish and maintain effective hedges.

The Proposing Release contains little to assuage our concerns. First, it notes that there would be little impact from a mandatory close-out requirement because it would affect a relatively small number of securities. The impact to options market makers in options involving those securities, however, would be great. Second, the proposing Release notes that existing fail positions of options market makers relying on the current exception would not have to be closed out immediately if the exception was abolished. That does not alleviate at all our concern that options market makers would find it risky to assume new hedge positions if the exemption is eliminated. Third, the Commission notes that the current exception only applies to positions in an underlying security that were put on before the security became a threshold security, and that the Commission is not aware of any evidence that the lack of an exception for new positions after a security becomes a threshold security affects options market makers willingness to continue to

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 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 Comment letter of The American Stock Exchange, Boston Options Exchange, Chicago Board Options Exchange, International Securities Exchange, NYSE/Arca, The Options Clearing Corporation, and Philadelphia Stock Exchange to the SEC on File No.S7-12-06, at 2 (April 30, 2007); Comment letter of The American Stock Exchange, Boston Options Exchange, Chicago Board Options Exchange, International Securities Exchange, NYSE/Arca, The Options Clearing Corporation, and Philadelphia Stock Exchange to the SEC on File No.S7-12-06, at 6 (September 22, 2006); 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 10 (February 9, 2004).

provide liquidity. The Commission provides no empirical evidence to support this contention. Our experience has been to the contrary: we believe that options market makers are less willing to provide liquidity if their ability to hedge in the underlying security is restricted.⁴ Finally, the Commission states that options market makers should be treated the same as equity market makers who have no exception from the threshold security close out requirements. The Commission's assertion does not recognize that the trading circumstances of the two types of market makers are very different. Options market makers transact in the underlying security merely to hedge an options position, while equity market makers actively trade equity securities. It is reasonable to treat the two market maker types differently for threshold security purposes. Otherwise, the end result would be inequitable. An equity market maker can freely hedge an equity position in a threshold security with a short options position but, if the options market maker exception is eliminated, options market makers would face restrictions in their ability to hedge options positions with the underlying equity.⁵

In short, the Commission has not made a convincing case that elimination of the options market maker exception will impose little cost on options market makers. We strongly believe that the costs would be significant and that options market making would be adversely affected by such a change. It makes little sense to risk this result in order to eliminate extended fails in a small number of threshold securities.⁶ We continue to strongly believe that any benefit of the eliminating the options market maker exception would be

⁴ A recent analysis by the Vodia Group supports this view. The analysis concludes that repeal of the options market maker exception would result in "a net reduction in all outstanding equity and index options contracts of 2.5% and a reduction of 87.7% in outstanding options contracts for hard to borrow underlying securities." See http://www.vodiagroup.com/pdfs/Reg_SHO_Options%20Exemption.pdf (September 17, 2007)

⁵ We understand that equities markets have used exemptive authority to grant relief to equity market makers from the close out requirements. Should the options market maker exception to the close out requirement be eliminated or narrowed, we believe that the same exemptive relief should be available to options markets and options market makers.

⁶ See Options Exchanges Comment Letter of April 30, 2007 at 2. This letter was in response to the Commission's reopening of the comment period on File No. S7-12-06 to receive comments on an analysis submitted by NASD on securities that remained on the NASDAQ Threshold List for 40 days or longer between January 10 and August 11, 2005. Of the 148 threshold securities analyzed by the NASD, only 5, or fewer than 3%, appear to have remained on the threshold list solely as the result of reliance on the options market maker exception.

very small compared to the costs imposed on options market making and the resultant harm to options customers and the options markets.

However, if the Commission is determined to either eliminate or drastically curtail the ability of options market makers to maintain open fail positions in threshold securities,⁷ we strongly support the Commission's proposed Alternative 1 to elimination of the options market maker exception over the Commission's proposed Alternative 2. Alternative 1 would require that open fails that result from short sales by an options market maker that were effected to establish or maintain a hedge before the security became a threshold security be closed out within 35 consecutive settlement days of the date on which the security becomes a threshold security. This alternative would provide additional time for options market makers to maintain an existing hedge, so that hedge positions could be managed or closed out in a relatively orderly fashion. Alternative 2 would require that open fails that result from short sales by an options market maker that were effected to establish or maintain a hedge before the security became a threshold security be closed out within the earlier of: (a) 35 consecutive settlement days of the date on which the security becomes a threshold security or (b) 13 consecutive settlement days from the last date on which all options series within the portfolio that were created before the underlying security becomes a threshold security expire or are liquidated.

Alternative 1 is preferable to elimination of the options market maker exception because it would provide options market makers some continued flexibility in conducting their hedging activities by allowing an extended period of time within which to close out fails to deliver in threshold securities. In addition, it would be easier for options market maker firms and their clearing firms to comply with Alternative 1 than Alternative 2.

⁷ We are aware that the Commission is under enormous pressure to target abusive "naked" short selling and to eliminate all persistent fails. Short selling serves a legitimate purpose in the market 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. The Commission's recent decision to eliminate the "grandfather" exception to Regulation SHO should significantly reduce persistent open fails even further. See 72 Fed. Reg. 45544 (August 14, 2007). However, even if all persistent open fails on threshold securities are eliminated, it is unlikely that pressure on the Commission regarding short sales will subside so long as short sales in any form are permitted and the stock prices of public companies are permitted to fall.

Exchanges would also find it easier to monitor compliance with Alternative 1 than Alternative 2.⁸ We suggest a minor, but very important, change to Alternative 1. Instead of allowing an options market maker 35 consecutive settlement days before he must cover or close out an extended fail position, we recommend that a market maker have 42 consecutive settlement days to do so. By extending the close out period by seven days, an options market maker can be assured of at least two options expirations before a fail position must be closed out. This will reduce the options market maker's risk of taking on a short position and enable the options market maker to unwind an extended fail in a more orderly manner. At the same time, the 42-day period will ensure that extended fails will be closed out by a date certain.⁹

The Commission is also proposing that any open fail position currently excepted from the close out requirements of Regulation SHO because it was established under the options market maker exception be closed out within 35 consecutive settlement days of the effective date of the proposed amendments to Regulation SHO. Adoption of this proposal will impose high costs on those options market makers who have relied on the options market maker exception and who will now have to close out fails that may have been open for months or years. It will fall particularly hard on those options market makers who have open fails in LEAPS. We suggest that the Commission permit a longer close out period for open fails held in reliance on the options market maker exception in LEAPS. We suggest that, at a minimum, fails associated with LEAPS positions be permitted to remain open until the option positions expire or are liquidated.

The Commission is also proposing a documentation requirement for broker-dealers marking orders to sell "long" pursuant to Regulation SHO that would require the broker-dealer to document the present location of the securities being sold. We believe that the imposition of this documentation

⁸ We support the use of settlement days, rather than calendar, to calculate the time in which to close out fails to deliver because it is consistent with the use of settlement days to calculate deadlines throughout Regulation SHO.

⁹ In addition, we continue to support an exemption from the close out requirements for ETFs. We support this approach because new ETF 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 selling of a company's stock.

Ms, Nancy Morris
September 19, 2007
Page 6 of 6

requirement would be unnecessarily burdensome.¹⁰ If the Commission does decide to adopt such a documentation requirement, we ask that the regulation clearly state who must perform the required locate and the information that the documentation needs to include. Clarity from the Commission on these points will make it easier for the Options Exchanges to monitor compliance with any new requirements.

Thank you again for the opportunity to comment on the Commission's proposal to eliminate the options market maker exception, the alternatives to eliminating the options market maker exception and the amendment to the marking requirements for "long" sales. 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

¹⁰ For example, an options market maker generally carries all of its positions with its clearing firm, so the documentation requirements would not seem to produce any beneficial information. Nonetheless, the documentation requirement would take additional time with which to comply and this delay could negatively impact execution quality. In this regard, we note that the Commission's proposal, which is based in part on NASD Rule 3370(b), fails to incorporate several essential exemptions that were included in the prior NASD rule.