Boston Options Exchange
Chicago Board Options Exchange
International Securities Exchange
NASDAQ Options Market
NASDAQ OMX PHLX
NYSE Alternext US [Amex]
NYSE Arca
The Options Clearing Corporation

December 19, 2008

Ms. Florence Harmon
Acting Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: File No. S7-30-08

Dear Ms. Harmon:

The Boston Options Exchange, the Chicago Board Options Exchange, the International Securities Exchange, NASDAQ Options Market, NASDAQ OMX PHLX, NYSE Alternext US [Amex], NYSE Arca, and The Options Clearing Corporation ("the Options Exchanges") appreciate the opportunity to comment on File No. S7-30-08 (the "Release") amending Regulation SHO, the Securities and Exchange Commission's ("Commission") primary regulation governing short sales.[1] In the Release, the Commission adopted an interim final temporary rule, Rule 204T (the "Rule"), which: (i) requires clearing firm participants to deliver equity securities sold on settlement date, or, if a clearing firm participant has a net "fail to deliver" position resulting from long sales or short sales, requires immediate close-out of the open "fail to deliver" position by borrowing or purchasing securities by no later than the beginning of trading on the next settlement day; and (ii) imposes penalties for failure to comply with the close-out requirement. The Rule contains certain exceptions from the requirement to close out fails to deliver by the next settlement day, including a limited exception for market makers, including options market makers. More specifically, if a fail to deliver is attributable to

[1] Securities Exchange Act, Release No. 58773 (October 14, 2008), 73 Fed. Reg. 67106 (October 17, 2008) (the "Interim Final Release").

registered market makers, including options market makers, engaged in bona fide market making activity, then such a fail to deliver position is required to be closed out by the beginning of trading on the third settlement day following the settlement date. If close-out does not occur within these timeframes, a clearing firm, and any broker-dealer from which it receives trades for clearance and settlement, is unable to affect further short sales in the particular security without first pre-borrowing or arranging to borrow the security. The Rule is very similar to the delivery requirements imposed by the Commission in its emergency order issued September 17, 2008.[2]

The Options Exchanges recognize that the Commission believed that extraordinary circumstances necessitated that it take emergency action regarding short sales and adopt Rule 204T as an interim final temporary rule. The Options Exchanges fully support the policy objectives behind the Commission's actions seeking to address potential manipulative activity. However, the Options Exchanges are also concerned that the Commission's actions have led to certain unintended consequences, which have had negative impacts on the markets. With respect to the emergency actions overall, imposing significant requirements without advance warning or input from the exchanges and market participants, but which must be complied with immediately, was and still is extremely disconcerting to all market participants. Adjustments to trading strategies and compliance systems that would be difficult, but possible, with reasonable advance notice become, in some situations, nearly impossible. Even when an emergency action ends, its impact lingers. For example, some market participants may be unaware of the end of emergency action despite the efforts of the industry and the Commission to inform them. While the majority of market participants may be aware of the end of emergency action, they may also be reluctant to resume their normal activities, based on a lingering concern that emergency action could again be imposed without warning. This uncertainty may lead options market makers to price this possibility into their bid-ask spreads, resulting in a widening of spreads. Furthermore, uncertainty leads customers to be tentative in their decision-making or to even become paralyzed into complete inactivity. The markets may likely suffer the effects of this lingering uncertainty for many months, if not longer.

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[2] Exchange Act Release No. 58572 (Sept. 17, 2008), 73 Fed. Reg. 54875 (Sept. 23, 2008) ("September Emergency Order").

With respect to Rule 204T, we are concerned that complying with the requirements of the Rule has caused, and will continue to cause, market volatility, increased borrowing costs, and wider bid/ask spreads.[3] The Options Exchanges believe that these negative market impacts could be significantly ameliorated by slightly extending the time for resolving fails to deliver. More specifically, we urge the Commission to amend the Rule to impose a uniform requirement that clearing firm participants take action to close out any fail to deliver position at a registered clearing agency that remains for five consecutive settlement days, namely by borrowing or purchasing securities by no later than the end of regular trading hours on the fifth consecutive settlement date. We believe that allowing fails to be resolved under this timeframe, and allowing a borrow to close out a fail through the end of the close-out timeframe, appropriately balances the Commission's concerns about the potential impact of persistent fails to deliver on investor confidence against the need to promote market efficiency and minimize market disruption.[4] We would strenuously oppose any decision to narrow the time for options market makers to resolve fails.

This recommended approach would essentially modify and extend the current close-out requirements of Rule 203(b)(3) of Regulation SHO which, by all accounts, has generally worked as intended to address fails to deliver without unduly impacting the markets. In this regard, Regulation SHO has generally focused on the prevention of large and persistent fails in a narrowly-tailored universe of "threshold securities."[5] This careful approach by the Commission was based on a legitimate concern, as expressed in the 2004 Regulation SHO Adopting Release, that prohibiting all fails "might be impracticable or an overly-broad method of addressing any potential abuses, and could also

[3] The Options Exchanges believe that Rule 204T is one of the factors that led November 2008 options volume to decrease 21% from November 2007 volume. Options market makers are facing higher stock borrowing costs, in part, because of Rule 204T. These higher borrowing costs must be priced into the options market maker's quotes leading to wider spreads and higher premiums. Options purchasers, used to years of tight options spreads, are reluctant to purchase options under these circumstances.

[4] In addition, consistent with the exemptive authority in Rule 203(d), the exchanges should be permitted to grant relief to these requirements by giving both equity or options market makers additional time to reduce fail positions where necessary to maintain a fair and orderly market.

[5] 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).

disrupt the efficient functioning of the Continuous Net Settlement system (''CNS'') operated by the National Securities Clearing Corporation (''NSCC'')."[6] As indicated by the Commission in the 2004 Regulation SHO Adopting Release, and in subsequent releases, fails occur for many legitimate reasons, and the Commission did not express concerns about the existence of a small number of fails remaining open beyond settlement date.[7] The Commission has engaged in various studies of Regulation SHO,[8] and repeatedly noted that, overall, Regulation SHO appears to be having its intended effects, as evidenced by a steadily-declining level of fails-to-deliver, as well as a declining number of threshold securities.[9] Equally important, the Commission has always stressed that the overall number of fails-to-deliver is also extremely low, with data from the NSCC showing that:

> 99% (by dollar value) of all trades settle on time. Thus, on an average day, approximately 1% (by dollar value) of all trades, including equity, debt and municipal securities fail to settle. The vast majority of these fails are closed out within five days after T+3."[10]

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6 Release No. 50103 (July 28, 2004), 69 Fed. Reg. 48008 n. 85 (Aug. 6, 2004) ("2004 Regulation SHO Adopting Release").

7 See, e.g., Exchange Act Release No. 56213 (Aug. 7, 2007), 72 Fed. Reg. 45558 (Aug. 14, 2007)("While the majority of trades settle on time, Regulation SHO is intended to address those situations where the level of fails to deliver for the particular stock is so substantial that it might impact the market for that security." (footnotes omitted)); Exchange Act Release No. 54154 (July 17, 2006); 21 Fed. Reg. 41710 at n. 2-4. (July 21, 2006).

8 Memorandum from the Commission's Office of Economic Analysis, dated August 21, 2006 (the "OEA Memo").

9 The following were among the figures cited by OEA: (i) The average daily aggregate fails to deliver declined by 34.0% after the effective date of Regulation SHO; (ii) the average daily number of threshold securities declined by 38.2% from the pre- to post-rule periods; (iii) the average daily fails of threshold securities declined by 52.4%; (iv) the average daily number of threshold securities declined by 29.8% from January 2005 to May 2006; (v) for exchange-listed issues, the average daily number of threshold securities during May 2006 was about 2.18% of all issues; (vi) for all issues traded in the U.S. (including OTCBB and Pink Sheets), the average daily number of threshold securities during May 2006 was about 0.38% of all issues; (vii) a total of 6,223 securities "graduated" from the threshold list since January 10, 2005, representing 4.5 billion shares in initial fails; (viii) only 6 securities have "persisted" on the threshold list since January 10, 2005, and even these 6 securities have seen their fails drop by 68.6%; (ix) 99.2% of the fails that existed on January 3, 2005 are no longer outstanding as of March 31, 2006.

10 Exchange Act Release No. 56213, 72 Fed. Reg. at 4558, n.5.

This being the case, the Commission has taken other action to address what it perceived to be persistent fails-to-deliver in a small handful of threshold securities, for example, by eliminating the Reg SHO "grandfather" provision, which had excepted from the Reg SHO close out requirement any fail-to-deliver positions established prior to a particular security becoming a threshold security.[11] On September 17, the Commission also adopted and made immediately effective the elimination of the options market maker exception from the close-out requirements of Regulation SHO applicable to threshold securities.[12] These actions should diminish significantly or even eliminate the already tiny fraction of extended fails in threshold securities that the Commission believes may undermine investor confidence.

In instituting Rule 204T, the Commission has now proceeded in a completely different direction, indicating that it has concerns about allowing *any* fails to deliver in *all* equity securities, rather than solely addressing extended fails in threshold securities. In essence, over the past few months, without following the normal notice and comment procedures of the Administrative Procedure Act and without permitting any implementation period, the Commission has imposed a no-fails requirement on all securities.

The Options Exchanges feel strongly that, while the September 17 emergency order and the current interim final temporary rule may have significantly decreased fails, they have also caused market volatility, raised borrowing costs and contributed to the widening of options bid/ask spreads. What is more, we understand that clearing firms are taking every precaution to avoid even the possibility of failing to deliver. This includes positions being closed out prior to settlement day to avoid possible assignment, even where it might make sense from a strategy perspective to maintain such positions. This activity increases market volatility as positions are closed at the end of the day in large numbers or in less-liquid extended trading sessions. Market participants are also finding that they need to either pre-borrow shares or pay to ensure that shares will be available in the event that they need to borrow them. Either activity raises the costs of short selling significantly. If the market participant is an options market maker, this increased cost of borrowing is passed onto customers in the form of wider bid/ask spreads.

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[11] Exchange Act Release No. 56212 (June 13, 2007), 72 Fed. Reg. 45544 (Aug. 14, 2007).

[12] September Emergency Order, supra. The Commission made elimination of the options market maker exception permanent on October 14, 2008. Exchange Act Release No. 58775, 73 Fed. Reg. 61690 (Oct. 17, 2008).

The Options Exchanges feel strongly that many of these unintended consequences of the Commission's "no-fails" policy could be ameliorated by slightly extending the time to resolve fails without penalty. As the Commission has noted a number of times, most recently in its release eliminating the options marker maker exception to the close-out requirements for threshold securities, in addition to 99% of all trades settling on time, the vast majority of all fails are resolved within five days after settlement day.[13] It is believed that these fails are usually not the result of any manipulative scheme but rather occur because of human or mechanical errors or processing delays. Extending the time to close out fails without penalty to five days after settlement day for all market participants would promote the Commission's goal of eliminating fails on all securities without unduly disrupting normal market function.[14]

Thank you again for the opportunity to comment on the Commission's interim final temporary rule requiring delivery of securities by settlement date, or three days after settlement date in the case of market makers. 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,

Boston Options Exchange
Chicago Board Options Exchange
International Securities Exchange
NASDAQ Options Market
NASDAQ OMX PHLX
NYSE Alternext US [AMEX]
NYSE Arca
The Options Clearing Corporation

cc: Erik Sirri
James Brigagliano

[13] Exchange Act Release No. 58775 at 3, n.7.

[14] We also recommend that the Commission move the time to resolve fails from prior to the beginning of regular trading hours to prior to the end of regular trading hours. This change will eliminate pressure on the open that could create undue market volatility and unfavorable fills for customers.