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SIG

SUSQUEHANNA INVESTMENT GROUP

AFFILIATE OF SUSQUEHANNA INT'L GROUP, LLP

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OFFICE OF THE SECRETARY

October 11, 2007

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

Re: Comments on Proposed Amendments to Regulation SHO
File No. S7-19-07

Ms. Morris:

I am writing on behalf of Susquehanna Investment Group (SIG)[1] to express concerns with the part of the proposal by the Securities and Exchange Commission ("Commission") referenced above ("the Proposal") to eliminate, or greatly reduce, the mandatory buy-in exception in threshold securities for options market makers[2] ("the exception"). We believe that withdrawing the exception completely, or limiting the exception to either of the proposed Alternatives, would have a significant negative impact on liquidity in the options markets in threshold and near-threshold[3] securities. We encourage the Commission to do further analysis on the potential loss of liquidity before proceeding.

Our own analysis suggests that withdrawing or greatly reducing the exception would cause varying losses of liquidity in over 20% of listed options and their underlying stocks. We expect that Options Market Makers (OMMs) will be generally cautious about committing liquidity in any option class that they consider to have significant mandatory buy-in risk, and we believe this concern applies in varying degrees to near-threshold as well as threshold option stocks. We estimate that the number of near-threshold stocks is normally far greater than the number of threshold stocks on any given day. As described more fully later in this letter, we calculated the number of near-threshold stocks by selecting option stocks with low rebate rates for short positions. Based on our analysis, we conclude that significant options liquidity will be lost in virtually all these affected option classes, and that the level of liquidity loss in many cases will be severe.

[1] SIG is a U.S. options exchange market maker in approximately 2,000 equity options.
[2] The mandatory buy-in applies to short positions in threshold securities that fail for 13 settlement days.
[3] Near-threshold refers generally to securities that have a strong possibility of becoming threshold in the near future.

As we believe that completely withdrawing the exception will greatly impact option liquidity, we were heartened to see alternatives presented in the Proposal. We are skeptical, however, that either alternative will be enough to keep OMMs fully committed as liquidity providers in the affected securities. Nevertheless, while the loss of liquidity would in both cases be significant, it would be far less for Alternative No. 1[4]. Of course, even in the case of Alternative No. 1, OMM liquidity would be significantly curtailed, given that an estimated 40% of equity option volume normally occurs in series with more than 35 days to expiration from the trade date. A far better proposal would be, as suggested by the CBOE, a somewhat longer settlement day period that would generally allow OMMs two expirations from trade date[5]. Although the CBOE suggested an alternative 42 day settlement day period, a 45 day period would more completely cover the two nearest-term expiration dates.

"Review Phase" Data Regarding Current Exception

The existing OMM threshold stock exception from the mandatory close-out requirement was instituted in early 2005. Although this should have provided ample opportunity for assessing its impact, it did not. Apparently, the manner of implementation regarding certain provisions became a source of misinterpretation and confusion within parts of the OMM community. Consequently, the data from the "review phase" is incomplete and observations from that time period are <u>not</u> indicative of how the rule, if implemented in its fullest form, affects liquidity. It appears, however, that much of the confusion and misinterpretation surrounding the original rule adoption was addressed in recent months by the options exchanges[6]. Thus, the impact to liquidity caused by the exception adoption, as it stands today, is becoming much clearer.

As we are now in a better position to assess the impact to liquidity in threshold stocks related to the exception, we believe the Commission should not act on the Proposal until further reviews of these effects can be conducted. In particular, we need to assess whether reducing extended fails, particularly those caused by OMMs, is now being accomplished through better implementation of existing rules. In this regard, we note that relatively few extended fails are currently caused by OMMs and this number, as small as it is, should be getting smaller in coming months by virtue of the exchange rule clarifications mentioned above[7].

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[4] Alternative No. 1 would require the mandatory buy-in of fails by OMMs after 35 settlement days.

[5] The CBOE presented its 42 Day possible alternative in its comment letter dated Sep 17, 2007.

[6] CBOE Regulatory Circular RG07-87 (Aug 9, 2007), Phlx Memorandum No. 2167-07 (Aug 24, 2007) and Amex Notice REG 2007-35 (Aug 9, 2007).

[7] An analysis by the NASD of threshold securities that appeared on NASDAQ's Threshold List for an extended-fail period in excess of 40 days during a certain period in 2005 revealed that there were 148 such instances. The NASD analysis indicated that the options market maker exception was involved in only a few instances involving fails to deliver of these threshold securities. In fact, only 5 of these unique issues, or fewer than 3%, appear to have been on the list as the result of the options market maker exception.

In light of the Proposal, and the possibility that the exception will be withdrawn or greatly reduced, OMMs have already begun to assess mandatory buy-in risks of affected securities. While this risk is most apparent in the case of threshold stocks that are the hardest to borrow, the risk profile of near-threshold option stocks is also changing. Although OMMs may continue to assume that many of these near-threshold stocks will not become threshold stocks anytime soon, they will not be able to very accurately forecast which ones will or won't. This being the case, OMMs will have no alternative but to treat all, or almost all, near-threshold securities as having added risk. This will result in a very broad and general withholding of liquidity by OMMs in options on near-threshold stocks as well as threshold stocks.

In order to reasonably calculate the total loss of OMM liquidity in options on near-threshold stocks, we need to have accurate estimates on the number of option stocks that will be considered by OMMs to be near-threshold. We believe the data for performing this task is already available, as described below.

Determining Near-Threshold Stocks

We examined options trading on the Chicago Board Options Exchange (CBOE) from January 2006 through August of 2007. The number of option classes listed on the CBOE during that period ranged from 1,786 in January 2006 to 2,330 in August 2007. We used June 2007 as our reference month, but our conclusions apply to any month selected.

Of the 2,242 stocks with option classes trading on the CBOE in June 2007, 174 (8%) appeared on the Threshold List for at least one day that month[8]. Starting at the beginning of June and looking forward over the three-month period of June through August, 356 (16%) of the stocks underlying CBOE option classes appeared on the Threshold List.

The possibility that 16% of all option stocks will appear on the Threshold List within three months of any given trade date would create a significant risk concern to OMMs. As a result, OMMs will be constantly attempting to identify which option stocks are most likely to become threshold in the near future. One commonly accepted predictor is whether a stock carries a low rebate rate for short positions. A sufficiently low rebate implies that the stock has already become very hard to borrow and is a risk to becoming threshold in the near future.

Thus, we hypothesize that a low (special) rebate rate on shorted stock is a qualifier that serves as a general predictor. Borrowing from a previous study, we defined the low (special) rate as any stock with a rebate rate of 25 basis points or more below the Federal

[8] June was actually the month with the lowest percentage of threshold stocks from the period May through August.

Reserve's target Fed Funds rate.[9] We examined each day in June 2007 for option stocks that were NOT at the time on the Threshold List but had a low rebate rate. For June 2007, there were 545 such stocks, representing over 23% of CBOE option classes. Of these 545 "special" stocks, 155 stocks (28%) later appeared on the Threshold List within ninety days of becoming special. These results suggest that OMMs have reason to be concerned about opening positions in stocks that are "special". We assume, however, that some of these option stocks will be subject to a special rebate condition that may be viewed by OMMs as a short term condition, which could relieve some concerns regarding options market making in those cases. Nonetheless, this number would be relatively few and would still leave well over 20% of listed option stocks with significant mandatory buy-in risk.

As a final point, an overarching concern is that not all mandatory buy-ins are equal. Although many result in small losses to the OMM, there can also occur mandatory buy-ins that expose OMMs to catastrophic losses. Identifying which option stocks carry the potential for catastrophic losses is just as difficult as predicting which near-threshold stocks will appear on the threshold list in the near future. With so much uncertainty and concern over hedging with such stocks, OMMs will have difficult choices regarding whether, and to what extent, to make option markets in the affected stocks. One thing does seem clear, however, we expect that quote spreads in near-threshold stock options will get wider across the board as OMMs spread the catastrophic risk among the many option stocks on the threshold and near-threshold lists.

Conclusion

We estimate that over 20% of listed option classes on any given day are either on the Threshold List or in a group of securities reasonably considered to be near-threshold. We believe that, if the exemption is withdrawn or greatly reduced, OMMs will withhold liquidity to varying degrees in the options overlying such stocks.

The over-20% estimate, in our view, is a conservative measure of option stocks that will lose OMM liquidity. To a limited extent, the actual loss of liquidity can be reduced in the event that an Alternative is chosen. Whether a complete withdrawal of the exemption or an Alternative is chosen, we believe OMMs will be cautious in the vast majority of threshold and near-threshold stocks. Even in the case of a "45 settlement day period" exception, making markets in further out months of such securities will still carry significant risks.

Consequently, we believe that the proposed elimination or great reduction of the options market maker exception would significantly harm the ability of options market makers to

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[9] See G. D'Avolio, 2002, "The Market for Borrowing Stock," *Journal of Financial Economics* 66, 271-306, for a justification of such a definition of special.

provide liquidity and would widen the bid and offer quotation for options in the affected securities to the detriment of options investors. We therefore urge the Commission to retain the exemption as currently written until this issue can be analyzed more completely.

Thank you for this opportunity to comment on the Proposal.

Sincerely,

Gerald D. O'Connell
SIG Compliance Coordinator

cc: The Hon. Christopher Cox, Chairman
The Hon. Paul Atkins, Commissioner
The Hon. Annette Nazareth, Commissioner
The Hon. Kathleen Casey, Commissioner
Dr. Erik Sirri, Director, Division of Market Regulation
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