November 27, 2007

Mr. Chairman & Members of the Commission Staff,

I welcome this opportunity to continue to dig into this proposed rule change to the Options Market Making (OMM) exemption.

**Background on Short Sale Policies:**

Currently, the SEC has clear policies on the process of a short sale transaction. Such policies are in place to provide efficiencies in the market trade process as well as to develop the growth of our capital markets. The SEC's position on the short sale policy was well documented in the original proposal to amend the short sale process back in October 2003.

*…short sale activities, in effect, add to the trading supply of stock available to purchasers and reduce the risk that the price paid by investors is artificially high because of a temporary contraction of supply.*[1]

The Commission policies on short sales contain boundaries in the process to insure that short sales are not overly burdensome to the markets by enforcing a locate and borrow policy. Without such restrictions the opposite affect of the short sale would be the contraction of demand and the potential for artificially low market pricing.

Certain exemptions do exist in the short sale policy for the stabilization of temporary volume occurrences. Such exemptions are afforded to market members working under a bona fide market-making role. It is this distinction between temporary and long term that needs to be addressed by this rule change.

**The Short Seller:**

Before proceeding to what is perceived as a flaw in the present proposal the Commission must define and better understand the short seller.

The short seller has two methods of executing a short sale under present SEC rule making.

1. Short the equity through the normal short sale process. This requires the member firm or client to locate an available share to borrow for the transfer of ownership to the buy side party in the short sale transaction. While this type of short sale has an indefinite window to closure, limitation exists in the execution based on the availability of shares to locate.
2. Short through a Put Option in the Options Market. The short seller can purchase the right to short shares through an options contract that can be forward looking up to several months or leap contracts forward looking several years. Presently, this type of short sale is void of any responsibility to locate or settle any trade executed into the equity market due to a hedge in the short sale option. This becomes an option for a short seller interested in a market where shares no longer exist to borrow or where the borrow rate is high.

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[1] SEC 2003 Proposal for Regulation SHO http://www.sec.gov/rules/concept/34-42037.htm

**The Flaw in this Proposal**

The underlying concept of this proposal, elimination of the OMM exemption in it's entirety is ultimately the only option the SEC should consider if the general principles of the short sale itself are to be maintained. The complete elimination would limit the market making exemptions in a short sale to the temporary market making activities necessary to address temporary liquidity but will not allow unlimited hedging (trading strategy) as an exemption.

Under Alternatives 1 and 2 the SEC is allowing the investor to effectively circumvent the protections of the short sale policies by shorting through the options market. Without limitations the impact such trading can have on the underlying equity is substantial. Suddenly the short sale volume becomes the dominant force in the market with little demand to absorb the intrusion.

Under both Alternative 1 and 2 the threshold security list comes into play. Efforts to curb the OMM exemptions and closeouts are limited to the issuer's presence on a threshold security list. The basic premise behind these alternatives is that the potential for abuse has reached unhealthy levels. This line of reasoning is flawed because it forgets about the delays in even achieving threshold status. This line of reasoning also goes against the basic principles of prompt settlement of all trades.

Under Alternatives 1 and 2 there is a commitment to close out all open fails in threshold securities by 35 days. Taking into consideration the 8-day delay between a trade and threshold status (T+3+5) fails can persist for 43 settlement days prior to closeout allowing the fails to burden the equity market beyond 2 full option contract periods.

Such a loophole is opportunity for smaller more volatile abuse periods. With the elimination of the tick test added into this equation the potential for abuse only increases.

As has already been seen and reported by the financial press in recent month, the Options Market is suddenly impacting directly the underlying equity and doing so through a trading strategy not allowed in the equity market – the short sale without a locate.

To further complicate the issue, the SEC is not firm in the demand for the 35 settlement day close out.

In the most recent proposal the SEC suggests:

*…hedge on any options series within a portfolio that were created before the security became a threshold security to close out the entire fail to deliver position, including any adjustments to that position, within 35 consecutive settlement days of the security becoming a threshold security.*

*In addition, similar to the pre-borrow requirement of Rule 203(b)(3)(iv) of Regulation SHO, if the fail to deliver position persists for 35 consecutive settlement days, the proposed alternative would prohibit a participant, and any broker-dealer for which it clears transactions, including market makers, from accepting any short sale orders or effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the entire fail to deliver position by purchasing securities of like kind and quantity.*[2]

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[2] SEC Proposed Amendments to SHO – Options Market Making http://www.sec.gov/rules/proposed/2007/34-56213.pdf

Taken literally, this language would imply that the mandatory closeout of a failure to deliver within 35 settlement days is only SEC guidance to the members and not a firm and unwavering stake in the ground. If the Commission intends to require the 35 settlement days as being firm, the alternative provisions identified in the second paragraph (pre-borrow on further short sales) would not be required as there would be no additional persistent fails beyond 35 days.

To this end, I believe the SEC should carefully think through and address such trading activities whereby fails to deliver executed through the use of an options market making hedge would not be able to be sufficiently close out within 35 consecutive trade days [7 calendar weeks] or less?

I personally believe the SEC's decision to stick with 35 calendar days is a weak argument and that the 35 days should be limited to no greater than one contract period if either of these poorly crafted Alternatives are to be considered.

Logistically, if SHO was actively working as planned the sell side market of a threshold security should no longer be dominated by trading that is not supported with a legitimate share. Short sales are theoretically under tighter trade restrictions and market makers have a higher risk of potential loss engaging in excessive bona fide market making of a threshold security. Thus, if a close-out could not be achieved over the course of nearly two months of trading it would be probable that the fails are due to several market inefficiencies:

1. The fails are at such excessive and unhealthy levels that the result is a significant level of long side fails taking place. Such an event would imply possible abuses in the market due to the excessive sell side dilution and the bailing of more recent purchasers.

2. Market participants continue to control the market offerings by selling naked short thus capping the natural market direction. This event would be necessary for the mitigation of future liabilities associated with buy-in activities. Allowing the market to appreciate would put the closeouts at risk of losses.

These are self-preservation techniques that only hurt the overall integrity of the market. To provide policy that allows the self-preservation above the rights of the general market is not an authority granted the Commission.

**Conclusions:**

Earlier this fall I was able to attend a conference conducted by DealFlow Media in which David Markowitz, SEC Assistant Regional Director NY Bureau addressed an audience of PIPE financiers and securities lawyers. As Mr. Markowitz responded to questions raised it became clear to the audience that Commission rules are at times conflicting in language and interpretation. Actions undertaken by the investing public and members are left to the arbitrary interpretation of any individual SEC enforcement attorney due to the ambiguity of the language drafted in the rule.

What one considers a violation is considered acceptable behavior by another leaving the public to guess about their actions. Mr. Marowitz frequently referred to a need to respond to each trading activity in a PIPE deal individually as to whether it was within the laws, which is the wrong way of thinking.

I believe that the proposed rule changes under comment, specifically Alternatives 1 or 2, likewise contain the conflicting message that will allow for future acts of fraud to escape enforcement action.

The SEC should be evaluating such policy changes based on the underlying principles of the market activity being questioned. In this case it is not the exemption that is under question but the foundation of a short sale and the rights of a short sale investor over the right of a long investor.

The SEC has created significant flexibility to the short sale process including bona fide market making exemptions to create temporary liquidity as well as the recent elimination of the tick test. Clearly all additional short sales must follow the protocols of prompt settlement. A hedged trade by an OMM against a short sale [PUT] executed by an investor is simply a transfer of the short sale interest by that investor. The equity market impact is identical to what would be seen if the short seller sold directly into the equity market without a proper locate.

In sports a bookie hedges by changing the line on a game to equalize the level of bets on that game. The bookie is ultimately looking for the Vig and not the score. OMM must likewise be expected to adjust the premiums set on the options contracts to equalize the markets. The Options Market must be transparent to the equities market and yet today, with the OMM exemption it is anything but transparent.

Thank you for serious consideration to this matter.

Dave Patch