SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 242

[Release No. 34–56213; File No. S7–19–07]

RIN 3235–AJ57

Amendments to Regulation SHO

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission (''Commission'') is re-proposing amendments to Regulation SHO under the Securities Exchange Act of 1934 (''Exchange Act''). The proposed amendments are intended to further reduce the number of persistent fails to deliver in certain equity securities by eliminating the options market maker exception. In addition, we are requesting comment regarding specific alternatives to our proposal to eliminate the options market maker exception.

We are also proposing an amendment to the long sale marking provisions of Regulation SHO that would require that brokers and dealers marking a sale as ''long'' document the present location of the securities being sold.

DATES: Comments should be received on or before September 13, 2007.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/proposed.shtml*); or
- Send an e-mail to *rule-comments@sec.gov*. Please include File Number S7–19–07 on the subject line; or
- Use the Federal eRulemaking Portal (*http://www.regulations.gov*). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549.

All submissions should refer to File Number S7–19–07. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/proposed.shtml*). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: James A. Brigagliano, Associate Director, Josephine J. Tao, Assistant Director, Victoria L. Crane, Branch Chief, Elizabeth A. Sandoe, Branch Chief, Joan M. Collopy, Special Counsel, and Lillian S. Hagen, Special Counsel, Office of Trading Practices and Processing, Division of Market Regulation, at (202) 551–5720, at the Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–6628.

SUPPLEMENTARY INFORMATION: The Commission is requesting public comment on proposed amendments to Rules 200 and 203 of Regulation SHO [17 CFR 242.200 and 242.203] under the Exchange Act.

I. Introduction

Regulation SHO, which became fully effective on January 3, 2005, sets forth the regulatory framework governing short sales.[1] Among other things, Regulation SHO imposes a close-out requirement to address failures to deliver stock on trade settlement date[2] and to target potentially abusive ''naked'' short selling[3] in certain equity securities.[4] While the majority of trades settle on time,[5] 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.[6] Although high fails levels exist only for a small percentage of issuers,[7] we are concerned that large and persistent fails to deliver may have a negative effect on the market in these securities. For example, large and persistent fails to deliver may deprive shareholders of the benefits of

[1] 17 CFR 242.200. *See also* Securities Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (Aug. 6, 2004) (''Adopting Release''), available at *http://www.sec.gov/rules/final/34-50103.htm.*

A short sale is the sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. In order to deliver the security to the purchaser, the short seller may borrow the security, typically from a broker-dealer or an institutional investor. The short seller later closes out the position by purchasing equivalent securities on the open market, or by using an equivalent security it already owns, and returning the security to the lender. In general, short selling is used to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand, or to hedge the risk of a long position in the same security or in a related security.

[2] Generally, investors must complete or settle their security transactions within three business days. This settlement cycle is known as T+3 (or ''trade date plus three days''). T+3 means that when the investor purchases a security, the purchaser's payment must be received by its brokerage firm no later than three business days after the trade is executed. When the investor sells a security, the seller must deliver its securities, in certificated or electronic form, to its brokerage firm no later than three business days after the sale. The three-day settlement period applies to most security transactions, including stocks, bonds, municipal securities, mutual funds traded through a brokerage firm, and limited partnerships that trade on an exchange. Government securities and stock options settle on the next business day following the trade. Because the Commission recognized that there are many legitimate reasons why broker-dealers may not deliver securities on settlement date, it adopted Rule 15c6–1, which prohibits broker-dealers from effecting or entering into a contract for the purchase or sale of a security that provides for payment of funds and delivery of securities later than the third business day after the date of the contract unless otherwise expressly agreed to by the parties at the time of the transaction. 17 CFR 240.15c6–1. However, failure to deliver securities on T+3 does not violate the rule.

[3] We have previously noted that abusive ''naked'' short selling, while not defined in the federal securities laws generally refers to selling short without having stock available for delivery and intentionally failing to deliver stock within the standard three day settlement cycle. *See* Securities Exchange Act Release No. 54154 (July 14, 2006), 71 FR 41710 (July 21, 2006) (''2006 Proposing Release'').

[4] In 2003, the Commission settled a case against certain parties relating to allegations of manipulative short selling in the stock of Sedona Corporation. The Commission alleged that the defendants profited from engaging in massive naked short selling that flooded the market with Sedona stock, and depressed its price. *See Rhino Advisors, Inc. and Thomas Badian,* Lit. Rel. No. 18003 (Feb. 27, 2003); *see also, SEC* v. *Rhino Advisors, Inc. and Thomas Badian,* Civ. Action No. 03 civ 1310 (RO) (S.D.N.Y). *See also,* Securities Exchange Act Release No. 48709 (Oct. 28, 2003), 68 FR 62972, 62975 (Nov. 6, 2003) (''2003 Proposing Release'') (describing the alleged activity in the case involving stock of Sedona Corporation); Adopting Release, 69 FR at 48016, n.76.

[5] According to the National Securities Clearing Corporation (''NSCC''), 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.

[6] These fails to deliver may result from either short or long sales of stock. There may be many reasons for a fail to deliver. For example, human or mechanical errors or processing delays can result from transferring securities in physical certificate rather than book-entry form, thus causing a failure to deliver on a long sale within the normal three-day settlement period. Also, broker-dealers that make a market in a security (''market makers'') and who sell short thinly-traded, illiquid stock in response to customer demand may encounter difficulty in obtaining securities when the time for delivery arrives.

[7] The average daily number of securities on a threshold list (as defined *infra* note 13) in March 2007 was approximately 311 securities, which comprised 0.39% of all equity securities, including those that are not covered by Regulation SHO. Regulation SHO's current close-out requirement applies to any equity security of an issuer that is registered under Section 12 of the Exchange Act, or that is required to file reports pursuant to Section 15(d) of the Exchange Act.

ownership, such as voting and lending. In addition, where a seller of securities fails to deliver securities on settlement date, in effect the seller unilaterally converts a securities contract (which should settle within the standard 3-day settlement period) into an undated futures-type contract, to which the buyer might not have agreed, or that might have been priced differently. Moreover, sellers that fail to deliver securities on settlement date may enjoy fewer restrictions than if they were required to deliver the securities within a reasonable period of time, and such sellers may attempt to use this additional freedom to engage in trading activities that are designed to improperly depress the price of a security.

In addition, many issuers and investors continue to express concerns about extended fails to deliver in connection with ''naked'' short selling.[8] To the extent that large and persistent fails to deliver might be indicative of manipulative ''naked'' short selling, which could be used as a tool to drive down a company's stock price, such fails to deliver may undermine the confidence of investors.[9] These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to such manipulative conduct.[10] In addition, issuers may believe that they have suffered unwarranted reputational damage due to investors' negative perceptions regarding large and persistent fails to deliver in the issuer's security.[11] Any unwarranted reputational damage caused by large and persistent fails to deliver might have an adverse impact on the security's price.[12]

The close-out requirement, which is contained in Rule 203(b)(3) of Regulation SHO, applies only to securities in which a substantial amount of fails to deliver have occurred (also known as ''threshold securities'').[13] As adopted in August 2004, Rule 203(b)(3) of Regulation SHO included two exceptions to the mandatory close-out requirement. The first was the ''grandfather'' provision, which excepted fails to deliver established prior to a security becoming a threshold security.[14] The second was the ''options market maker exception,'' which excepted any fail to deliver in a threshold security resulting from short sales effected by a registered options market maker to establish or maintain a hedge on options positions that were created before the underlying security became a threshold security.[15]

At the time of Regulation SHO's adoption, the Commission stated that it would monitor the operation of Regulation SHO to determine whether grandfathered fail to deliver positions were being cleared up under the existing delivery and settlement guidelines or whether any further regulatory action with respect to the close out provisions of Regulation SHO was warranted.[16] In addition, with respect to the options market maker exception, the Commission noted that it would take into consideration any indications that this provision was operating significantly differently from the Commission's original expectations.[17]

Based, in part, on the results of examinations conducted by the Commission's staff and the SROs since Regulation SHO's adoption, as well as the persistence of certain securities on threshold securities lists, on July 14, 2006, the Commission published proposed amendments to Regulation SHO,[18] which were intended to reduce the number of persistent fails to deliver in certain equity securities by eliminating the grandfather provision and narrowing the options market maker exception contained in that rule. In addition, in March 2007, the Commission re-opened the comment period to the 2006 Proposing Release for thirty days to provide the public with an opportunity to comment on a summary of the National Association of Securities Dealers, Inc.'s (''NASD's'') analysis that the NASD had submitted to the public file on March 12, 2007. In addition, the notice regarding the re-opening of the comment period directed the public's attention to summaries of data collected by the Commission's Office of Compliance Inspections and Examinations and the New York Stock Exchange LLC (''NYSE'').[19]

On June 13, 2007, in a companion rule to this proposal, after careful consideration of public comments, we approved the adoption of the amendment, as proposed, to eliminate the grandfather provision of Regulation

[8] *See, e.g.*, letter from Patrick M. Byrne, Chairman and Chief Executive Officer, Overstock.com, Inc., dated Sept. 11, 2006 (''Overstock''); letter from Daniel Behrendt, Chief Financial Officer, and Douglas Klint, General Counsel, TASER International, dated Sept. 18, 2006 (''TASER''); letter from John Royce, dated April 30, 2007; letter from Michael Read, dated April 29, 2007; letter from Robert DeVivo, dated April 26, 2007; letter from Ahmed Akhtar, dated April 26, 2007.

[9] *See, e.g.*, letter from Mary Helburn, Executive Director, National Coalition Against Naked Shorting, dated Sept. 30, 2006 (''NCANS''); letter from Richard Blumenthal, Attorney General, State of Connecticut, dated Sept. 19, 2006 (''State of Connecticut'') (discussing the impact of fails to deliver on investor confidence).

[10] *See, e.g.*, letter from Congressman Tom Feeney—Florida, U.S. House of Representatives, dated Sept. 25, 2006 (''Feeney'') (expressing concern about the impact of potential ''naked'' short selling on capital formation, claiming that ''naked'' short selling causes a drop in an issuer's stock price and may limit the issuer's ability to access the capital markets); letter from Zix Corporation, dated Sept. 19, 2006 (''Zix'') (stating that ''[m]any investors attribute the Company's frequent re-appearances on the Regulation SHO list to manipulative short selling and frequently demand that the Company ''do something'' about the perceived manipulative short selling. This perception that manipulative short selling of the Company's securities is continually occurring has undermined the confidence of many of the Company's investors in the integrity of the market for the Company's securities'').

[11] Due, in part, to such concerns, issuers have taken actions to attempt to make transfer of their securities ''custody only,'' thus preventing transfer of their stock to or from securities intermediaries such as the Depository Trust Company (''DTC'') or broker-dealers. A number of issuers have attempted to withdraw their issued securities on deposit at DTC, which makes the securities ineligible for book-entry transfer at a securities depository. We note, however, that in 2003 the Commission approved a DTC rule change clarifying that its rules provide that only its participants may withdraw securities from their accounts at DTC, and establishing a procedure to process issuer withdrawal requests. *See* Securities Exchange Act Release No. 47978 (June 4, 2003), 68 FR 35037 (June 11, 2003).

[12] *See also* 2006 Proposing Release, 71 FR at 41712 (discussing the impact of large and persistent fails to deliver on the market). *See also* 2003 Proposing Release, 68 FR at 62975 (discussing the impact of ''naked'' short selling on the market).

[13] A threshold security is defined in Rule 203(c)(6) as any equity security of an issuer that is registered pursuant to section 12 of the Exchange Act (15 U.S.C. 78*l*) or for which the issuer is required to file reports pursuant to section 15(d) of the Exchange Act (15 U.S.C. 78o(d)): (i) 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 (ii) that is included on a list (''threshold securities list'') disseminated to its members by a self-regulatory organization (''SRO''). *See* 17 CFR 242.203(c)(6). Each SRO is responsible for providing the threshold securities list for those securities for which the SRO is the primary market.

[14] *See* Adopting Release, 69 FR at 48031. The ''grandfathered'' status applied in two situations: (i) to fail to deliver positions occurring before January 3, 2005, Regulation SHO's effective date; and (ii) to fail to deliver positions that were established on or after January 3, 2005 but prior to the security appearing on a threshold securities list.

[15] *See* Adopting Release, 69 FR at 48031.

[16] *See id.* at 48018.

[17] *See id.* at 48019.

[18] *See* 2006 Proposing Release, 71 FR 41719.

[19] In formulating its proposal to eliminate the grandfather provision and narrow the options market maker exception of Regulation SHO, the Commission relied in part on data collected by the NASD. In response to commenters' concerns regarding the public availability of data relied on by the Commission, we re-opened the comment period to the 2006 Proposing Release for thirty days to provide the public with an opportunity to comment on a summary of the NASD's analysis that the NASD had submitted to the public file on March 12, 2007. *See* Securities Exchange Act Release No. 55520 (March 26, 2007), 72 FR 15079 (March 30, 2007) (''Regulation SHO Re-Opening Release'').

SHO.[20] With respect to the options market maker exception, however, in response to comments to the 2006 Proposing Release, we are re-proposing amendments to the current options market maker exception that would eliminate the exception.

We are concerned that persistent fails to deliver will continue in certain equity securities unless the options market maker exception is eliminated entirely. Thus, as discussed more fully below, our proposal would modify Rule 203(b)(3) by eliminating the exception. In addition, we are requesting comment regarding alternatives to eliminating the options market maker exception that would require fails to deliver in threshold securities underlying options to be closed out within specific time-frames.

We are also proposing an amendment to the long sale marking provisions of Rule 200(g)(1) of Regulation SHO that would require that brokers and dealers marking a sale as ''long'' document the present location of the securities.

II. Background

A. Rule 203(b)(3)'s Close-out Requirement

One of Regulation SHO's primary goals is to reduce fails to deliver in those securities with a substantial amount of fails to deliver by imposing additional delivery requirements on participants of a registered clearing agency with fails to deliver in these securities.[21] As discussed above, we believe that additional delivery requirements help protect and enhance the operation, integrity and stability of the markets, as well as reduce short selling abuses.

Thus, Rule 203(b)(3)'s close-out requirement requires a participant of a clearing agency registered with the Commission [22] to take immediate action to close out a fail to deliver position in a threshold security in the Continuous Net Settlement (''CNS'') [23] system that has persisted for 13 consecutive settlement days by purchasing securities of like kind and quantity.[24] In addition, if the failure to deliver has persisted for 13 consecutive settlement days, Rule 203(b)(3)(iv) prohibits the 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 fail to deliver position by purchasing securities of like kind and quantity.[25]

B. Regulation SHO's Options Market Maker Exception

1. Current Options Market Maker Exception

Regulation SHO's options market maker exception excepts from the close-out requirement of Rule 203(b)(3) any fail to deliver position in a threshold security that is attributed to short sales by a registered options market maker, if and to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on options positions that were created before the security became a threshold security.[26] The options market maker exception was created to address concerns regarding liquidity and the pricing of options.[27] The exception does not require that such fails to deliver be closed out.

Since Regulation SHO's effective date in January, 2005, the Staff and the SROs have been examining firms for compliance with Regulation SHO, including the close-out provisions. We have received preliminary data that indicates that Regulation SHO appears to be significantly reducing fails to deliver without disruption to the market.[28] However, despite this positive

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[20] *See* Securities Exchange Act Release No. 56212 (Aug. 7, 2007).

[21] *See* Adopting Release, 69 FR at 48009.

[22] For purposes of Regulation SHO, the term ''participant'' has the same meaning as in section 3(a)(24) of the Exchange Act. *See* 15 U.S.C. 78c(a)(24). The term ''registered clearing agency'' means a clearing agency, as defined in section 3(a)(23) of the Exchange Act, that is registered as such pursuant to section 17A of the Exchange Act. *See* 15 U.S.C. 78c(a)(23)(A), 78q–1 and 15 U.S.C. 78q–1(b), respectively. *See also,* Adopting Release, 69 FR at 48031. As of May 2007, approximately 90% of participants of the NSCC, the primary registered clearing agency responsible for clearing U.S. transactions, were registered as broker-dealers. Those participants not registered as broker-dealers include such entities as banks, U.S.-registered exchanges, and clearing agencies. Although these entities are participants of a registered clearing agency, generally these entities do not engage in the types of activities that would implicate the close-out requirements of Regulation SHO. Such activities of these entities include creating and redeeming Exchange Traded Funds, trading in municipal securities, and using NSCC's Envelope Settlement Service or Inter-city Envelope Settlement Service. These activities rarely lead to fails to deliver and, if fails to deliver do occur, they are small in number and are usually closed out within a day. Thus, such fails to deliver would not trigger the close-out provisions of Regulation SHO.

[23] The majority of equity trades in the United States are cleared and settled through systems administered by clearing agencies registered with the Commission. The National Securities Clearing Corporation (''NSCC'') clears and settles the majority of equity securities trades conducted on the exchanges and over the counter. NSCC clears and settles trades through the CNS system, which nets the securities delivery and payment obligations of all of its members. NSCC notifies its members of their securities delivery and payment obligations daily. In addition, NSCC guarantees the completion of all transactions and interposes itself as the contraparty to both sides of the transaction. While NSCC's rules do not authorize it to require member firms to close out or otherwise resolve fails to deliver, NSCC reports to the SROs those securities with fails to deliver of 10,000 shares or more. The SROs use NSCC fails data to determine which securities are threshold securities for purposes of Regulation SHO.

[24] 17 CFR 242.203(b)(3).

[25] *Id.* at (b)(3)(iv). It is possible under Regulation SHO that a close out by a participant of a registered clearing agency may result in a fail to deliver position at another participant if the counterparty from which the participant purchases securities fails to deliver. However, Regulation SHO prohibits a participant of a registered clearing agency, or a broker-dealer for which it clears transactions, from engaging in ''sham close outs'' by entering into an arrangement with a counterparty to purchase securities for purposes of closing out a fail to deliver position and the purchaser knows or has reason to know that the counterparty will not deliver the securities, and which thus creates another fail to deliver position. *See id.* at (b)(3)(vii); Adopting Release, 69 FR at 48018 n.96. In addition, we note that borrowing securities, or otherwise entering into an arrangement with another person to create the appearance of a purchase would not satisfy the close-out requirement of Regulation SHO. For example, the purchase of paired positions of stock and options that are designed to create the appearance of a bona fide purchase of securities but that are nothing more than a temporary stock lending arrangement would not satisfy Regulation SHO's close-out requirement.

[26] 17 CFR 242.203(b)(3)(iii).

[27] In response to the proposal to adopt Regulation SHO and the Commission's determination at that time not to provide an exception for market makers, including options market makers, from the delivery requirements of proposed Regulation SHO, the Commission received letters that stated that the effect of not including such an exception would be to cease altogether options trading in securities that are difficult to borrow, as it was argued that no options market makers would make markets without the ability to hedge by selling short the underlying security. In addition, one commenter stated that the heightened delivery requirements of proposed Regulation SHO for threshold securities could drain liquidity in other securities where there is no current indication of significant settlement failures. The commenter believed that, while a blanket exception would be preferable, at a minimum the implementation of any such provision should not apply to market maker positions acquired prior to the effective date of the rule, and likewise should not apply to any short position acquired prior to the time that the subject security meets the designated threshold. See Adopting Release, 69 FR at 48019 (discussing the comment letters received in response to the delivery requirements of proposed Regulation SHO). In part, in response to these comments, we adopted a limited options market maker exception to the close-out requirement of Regulation SHO. As discussed in more detail in this release and, in particular, in Section II.B.3. below, we no longer believe that the current options market maker exception is necessary.

[28] For example, in comparing a period prior to the effective date of the current rule (April 1, 2004 to December 31, 2004) to a period following the effective date of the current rule (January 1, 2005 to March 31, 2007) for all stocks with aggregate fails to deliver of 10,000 shares or more as reported by NSCC:

- The average daily aggregate fails to deliver declined by 29.5%;

impact, we continue to observe a small number of threshold securities with substantial and persistent fail to deliver positions that are not being closed out under existing delivery and settlement requirements.

Based on the examinations and our discussions with the SROs and market participants, we believe that these persistent fail to deliver positions may be attributable, in part, to reliance on the options market maker exception.[29] Accordingly, on July 14, 2006, the Commission published the 2006 Proposing Release that included proposed amendments to limit the duration of the options market maker exception.[30]

The Commission, in the 2006 Proposing Release, proposed that for securities that are threshold securities on the effective date of the amendment, any previously excepted fail to deliver position in the threshold security that resulted from short sales effected by a registered options market maker to establish or maintain a hedge on an options position that existed before the security became a threshold security, but that has expired or been liquidated on or before the effective date of the amendment, would be required to be closed out within 35 consecutive settlement days of the effective date of the amendment. In addition, if the fail to deliver position persisted for 35 consecutive settlement days, the proposal would have prohibited a participant of a registered clearing agency, 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 closed out the entire fail to deliver position by purchasing securities of like kind and quantity.

If the security became a threshold security after the effective date of the amendment, all fail to deliver positions in the security that result or resulted from short sales effected by a registered options market maker to establish or maintain a hedge on an options position that existed before the security became a threshold security would have to be closed out within 13 consecutive settlement days of the security becoming a threshold security or of the expiration or liquidation of the options position, whichever was later. In addition, if the fail to deliver position persisted for 13 consecutive settlement days from the date on which the security became a threshold security or the options position had expired or was liquidated, whichever was later, the proposal would have prohibited a participant of a registered clearing agency, 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 closed out the entire fail to deliver position by purchasing securities of like kind and quantity.

Thus, under the 2006 Proposing Release, registered options market makers would still have been able to continue to keep open fail to deliver positions in threshold securities that resulted from short sales to hedge an options position created prior to the time the underlying security became a threshold security, provided the options position had not expired or been liquidated. Once the underlying security became a threshold security and the specific options position being hedged had expired or been liquidated, however, such fails to deliver would have been subject to a 13 consecutive settlement day close-out requirement.

2. Comments to the 2006 Proposing Release

We received a number of comment letters on the proposed narrowing of the options market maker exception from a variety of entities including options market makers, SROs, associations, issuers, an academic, and individual retail investors.[31]

Several commenters supported the proposal to narrow the options market maker exception. For example, one commenter stated that 13 consecutive settlement days was more than a sufficient amount of time in which to close out a fail to deliver position relating to an options position.[32] Another commenter stated that it believes the current ''exemption can be exploited to manipulate prices downward by manipulators buying large numbers of put options in already heavily-shorted securities.'' [33] Some of these commenters recommended that the Commission eliminate the options market maker exception altogether,[34] or, reduce the close-out requirement to five consecutive settlement days.[35] In addition, commenters that supported the proposal to narrow the options market maker exception also urged the Commission to enhance the documentation requirements for establishing eligibility for the exception.[36]

Commenters who opposed the proposal to narrow the options market maker exception stated that the proposed amendments would disrupt the markets because they would not provide sufficient flexibility to permit efficient hedging by options market makers, would unnecessarily increase risks and costs to hedge, and would adversely impact liquidity and result in higher costs to customers.[37] These commenters stated that they believe the proposed amendments would likely

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• The average daily number of securities with aggregate fails to deliver of at least 10,000 shares declined by 5.8%;

• The average daily number of fails to deliver declined by 15.1%;

• The average age of a fail to deliver position declined by 25.5%;

• The average daily number of threshold securities declined by 39.0%; and

• The average daily fails to deliver of threshold securities declined by 52.9%.

See also supra note 7.

[29] As noted in the 2006 Proposing Release and the Regulation SHO Re-Opening Release, we believe that the persistent fails to deliver may be attributable primarily to the grandfather provision and, secondarily, to reliance on the options market maker exception. *See* 2006 Proposing Release, 71 FR at 41712; Regulation SHO Re-Opening Release, 72 FR at 15079 (providing a summary of data received from certain SROs regarding reasons for the extended fails to deliver).

[30] *See* 2006 Proposing Release, 71 FR at 41722.

[31] *See, e.g.*, letter from Overstock, *supra* note 8; letter from NCANS, *supra* note 9; letter from Joseph P. Borg, Esq., President, North American Securities Administrators Association, Inc., dated Oct. 4, 2006 (''NASAA''); letter from TASER, *supra* note 8; letter from James J. Angel, PhD, CFA, dated July 18, 2006 (''Angel''); letter from Margaret Wiermanski, Chief Operations Officer and Matthew Abraham, Compliance Officer, CTC LLC, dated Sept. 28, 2006 (''CTC LLC''); letter from Timothy D. Lobach, Keystone Trading Partners, dated Sept. 19, 2006 (''Keystone''); letter from Steve Keltz, General Counsel, Citigroup Derivatives Markets, Inc., dated Sept. 29, 2006 (''Citigroup''); letter from Robert Bellick, Managing Director, Chris Gust, Managing Director, and Megan Flaherty, Director of Compliance and Chief Legal Counsel, Wolverine Trading LLC, dated Sept. 25, 2006 (''Wolverine''); letter from Edward J. Joyce, President and Chief Operating Officer, Chicago Board Options Exchange, dated October 11, 2006 (''CBOE''); letter from The American Stock Exchange, Boston Options Exchange, Chicago Board Options Exchange, International Securities Exchange, NYSE/Arca, The Options Clearing Corporation, Philadelphia Stock Exchange, dated Sept. 22, 2006 (''Options Exchanges''); letter from Ira D. Hammerman, Senior Vice President and General Counsel, Securities Industry Association, dated Sept. 19, 2006 (''SIA''); letter from Keith F. Higgins, Chair, Committee on Federal Regulation of Securities, American Bar Association Section of Business Law, dated Sept. 27, 2006 (''ABA''); letter from Gerard S. Citera, Executive Director, U.S. Equities, UBS Securities LLC, dated Sept. 22, 2006 (''UBS'').

[32] *See* letter from Overstock, *supra* note 8.

[33] *See* letter from NCANS, *supra* note 9.

[34] *See, e.g., id.*

[35] *See* letter from NASAA, *supra* note 31.

[36] *See, e.g., id.*; TASER, *supra* note 8.

[37] *See, e.g.*, letter from CBOE, *supra* note 31.

discourage options market makers from making markets in illiquid securities since the risk associated in maintaining the hedges in these option positions would be too great.[38] Moreover, these commenters claimed that the reluctance of options market makers to make markets in threshold securities would result in wider spreads in such securities to account for the increased costs of hedging, to the detriment of investors.[39]

Many of the commenters who opposed the proposal to narrow the options market maker exception argued that the requirement that fail to deliver positions be closed out upon liquidation or expiration of a specifically hedged options position was impracticable, given that the industry practice is to use hedges to manage risk of an entire inventory, not just a specific options position.[40] These commenters noted that options market makers typically facilitate an investor's rolling of an existing options position to either a different strike price within the same expiration month or to a future month as expiration approaches, and retain the short position to hedge the new options position.[41] These commenters argued that the amendment would require the options market maker to buy in the short position and/or pre-borrow to maintain a hedge, even though the overall position may have changed very little from a risk perspective, which, they argued, could potentially be a costly and time consuming measure.[42]

Commenters who opposed the proposed amendments to the options market maker exception favored maintaining the current exception, which they believe is already narrowly tailored.[43] For example, one commenter stated that it believes the current exception preserves the integrity of legitimate hedging practices and prevents manipulative short squeezes.[44] Another commenter stated that the current exception enables it to better service market participants by allowing it to continuously quote and disseminate bids and offers even where it may be difficult to borrow certain stock.[45] Another commenter stated that it is unaware of any statistics establishing that fails to deliver attributable to legitimate options market making activity are correlated to abusive short selling practices, and cautioned that ''the possible detrimental effects on options markets in threshold securities should first be quantified to guard against an unanticipated, significant peril to another facet of the capital markets.'' [46]

3. Response to Comments to the 2006 Proposing Release

We proposed to narrow the options market maker exception in Regulation SHO because we are concerned about large and persistent fails to deliver in threshold securities attributable, in part, to the options market maker exception, and our concerns that such fails to deliver might have a negative effect on the market in these securities.[47]

Regulation SHO's options market maker exception does not require fails to deliver to be closed out if they resulted from short sales effected by registered options market makers to establish or maintain a hedge on options positions established before the underlying security became a threshold security. For the reasons discussed below, although we recognize commenters' concerns that a mandatory close-out requirement for fails to deliver in threshold securities underlying options positions could potentially impact options market makers' willingness to provide liquidity in threshold securities, make it more costly for options market makers to accommodate customer buy orders, or result in wider bid-ask spreads or less depth, we believe that such an impact, if any, would be minimal.

First, we believe that the potential effects, if any, of a mandatory close-out requirement would be minimal because the number of securities that would be impacted by a mandatory close-out requirement would be relatively small. Regulation SHO's close-out requirement is narrowly tailored in that it targets only those securities where the level of fails to deliver is high (0.5% of total shares outstanding and 10,000 shares or more) for a continuous period (five consecutive settlement days).[48] Requiring close-out only for securities with large and persistent fails to deliver limits the overall market impact. In addition, as noted by one commenter, a small number of securities that meet the definition of a ''threshold security'' have listed options, and those securities form a very small percentage of all securities that have options traded on them.[49] Moreover, the current options market maker exception only excepts from Regulation SHO's mandatory 13 consecutive settlement day close-out requirement those fail to deliver positions that result from short sales effected by registered options market makers to establish or maintain a hedge on options positions established *before* the underlying security became a threshold security. Thus, it does not apply to fails to deliver resulting from short sales effected to establish or maintain a hedge on options positions established *after* the underlying security became a threshold security. Because the current options market maker exception has a very limited application, the overall impact of its removal on liquidity, hedging costs, spreads, and depth, should be relatively small.

Second, to the extent that a mandatory close-out requirement could potentially impact options market makers' willingness to provide liquidity in threshold securities, make it more costly for options market makers to accommodate customer buy orders, or result in wider bid-ask spreads or less depth, we believe that any such potential effects would likely be mitigated by the fact that even though fails to deliver that were previously-excepted from the close-out requirement of Regulation SHO would not be permitted to continue indefinitely, such fails to deliver would not have to be closed out immediately, or even within the standard 3-day settlement period. Instead, under a mandatory close-out requirement, such as that imposed

[38] *See id.*

[39] *See* letter from Citigroup, *supra* note 31.

[40] For example, CBOE stated that options market makers hedge on a class basis and, therefore, as options positions are rolled to forward months, the options market maker may need to maintain the hedge. Thus, the stock position would need to be maintained not because it hedges a particular series, but because it maintains a delta of an overall position. *See* letter from CBOE, *supra* note 31. *See, also*, letters from CTC LLC, *supra* note 31; Citigroup, *supra* note 31; Wolverine, *supra* note 31.

[41] *See, e.g.*, letters from Citigroup, *supra* note 31; Wolverine, *supra* note 31; Options Exchanges, *supra* note 31.

[42] *See, e.g.*, letters from Wolverine, *supra* note 31; Citigroup, *supra* note 31.

[43] *See id.*

[44] *See* letter from Keystone, *supra* note 31.

[45] *See* letter from Citigroup, *supra* note 31.

[46] *See* letter from CTC LLC, *supra* note 31. Statistical evidence of options market maker failing practices can be found in *Failure is an Option: Impediments to Short Selling and Options Prices* by Evans, Geczy, Musto, and Reed, forthcoming in the *Review of Financial Studies. See http://finance.wharton.upenn.edu/~musto/papers/egmr.pdf.*

[47] *See* 2006 Proposing Release, 71 FR at 41711–41712; *see also*, Regulation SHO Re-Opening Release, 72 FR 15079–15080. *See also*, discussion above in Section I. Introduction.

[48] *See supra* note 7 (discussing the number of threshold securities as of March 31, 2007).

[49] *See* letter from Options Exchanges, *supra* note 31 (noting that as of the date of the 2006 Proposing Release, approximately 84 of the approximately 300 threshold securities had options traded on them). This commenter also noted that ''options on a number of these threshold securities are very actively traded as are the securities themselves. Among the actively traded threshold securities with active options trading are iShares Russell 2000 ETF, Avanir Pharmaceuticals, Krispy Kreme Donuts, Martha Stewart Living Omnimedia, Mittal Steel, Navarre Corp., and Novastar Financial.'' *See id.*

currently by the 13 consecutive settlement day requirement of Rule 203(b)(3) of Regulation SHO, fails to deliver in threshold securities would have an extended period of time within which to be closed out. An extended close-out requirement would provide options market makers with some flexibility in conducting their hedging activities in that it would allow them to not buy-in a fail to deliver position or pre-borrow to maintain a hedge for the time that the fail to deliver position can remain open.

Third, as noted above, Regulation SHO's current options market maker exception is limited to only those fail to deliver positions that result from short sales effected by registered options market makers to establish or maintain a hedge on options positions established *before* the underlying security became a threshold security. Thus, it does not apply to fails to deliver resulting from short sales effected to establish or maintain a hedge on options positions established *after* the underlying security became a threshold security. In examining the application of the current mandatory close-out requirement of Regulation SHO for all non-excepted fail to deliver positions, we have not become aware of any evidence that the current close-out requirement for non-excepted fails to deliver in threshold securities has impacted options market makers' willingness to provide liquidity in threshold securities, made it more costly for options market makers to accommodate customer orders, or resulted in wider bid-ask spreads or less depth.

Similarly, all fails to deliver in threshold securities resulting from long or short sales of securities in the equities markets must be closed out in accordance with Regulation SHO's mandatory 13 consecutive settlement day close-out requirement, and we are not aware that such a requirement has impacted the willingness of market makers to make markets in securities subject to the close-out requirement, or led to decreased liquidity, wider spreads, or less depth in these securities. Thus, we believe that the impact of requiring that fails to deliver in threshold securities resulting from short sales to hedge options positions created before the security became a threshold security be closed out would similarly be minimal, if any.

Fourth, to the extent that a mandatory close-out requirement for all fails to deliver resulting from hedging activity in the options markets could potentially impact liquidity, hedging costs, depth, or spreads, or impact the willingness of options market makers to make markets in certain securities, we believe that such effects are justified by our belief, as discussed in more detail below, that fails to deliver resulting from hedging activities by options market makers should be treated similarly to fails to deliver resulting from sales in the equities markets so that market participants trading threshold securities in the options markets do not receive an advantage over those trading such securities in the equities markets.

Fifth, to the extent that a mandatory close-out requirement for all fails to deliver resulting from hedging activity in the options markets could potentially impact liquidity, hedging costs, depth, or spreads, or impact the willingness of options market makers to make a market in certain securities, we believe that these potential effects are justified by the benefits of requiring that fails to deliver in all threshold securities be closed out within specific time-frames rather than being allowed to continue indefinitely. As discussed above, large and persistent fails to deliver can deprive shareholders of the benefits of ownership, such as voting and lending. They can also be indicative of potentially manipulative conduct, such as abusive ''naked'' short selling. The deprivation of the benefits of ownership, as well as the perception that abusive ''naked'' short selling is occurring in certain securities, can undermine the confidence of investors. These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to manipulative conduct.

In the 2006 Proposing Release, we sought comment on whether the proposed amendments would promote capital formation, including whether the proposed increased short sale restrictions would affect investors' decisions to invest in certain equity securities. Commenters expressed concern about ''naked'' short selling causing a drop in an issuer's stock price and that it may limit an issuer's ability to access the capital markets.[50] We believe that, by requiring that all fails to deliver in threshold securities be closed out within specific time-frames rather than allowing them to continue indefinitely, there would be a decrease in the number of threshold securities with persistent and high levels of fails to deliver. If persistence on the threshold securities lists leads to an unwarranted decline in investor confidence about the security, the proposed amendments should improve investor confidence about the security. We also believe that the proposed amendments should lead to greater certainty in the settlement of securities which should strengthen investor confidence in the settlement process. The reduction in fails to deliver and the resulting reduction in the number of securities on the threshold securities lists could result in increased investor confidence, and the promotion of price efficiency and capital formation.

Due to our concerns about the potentially negative market impact of large and persistent fails to deliver, and the fact that we continue to observe a small number of threshold securities with fail to deliver positions that are not being closed out under existing delivery and settlement requirements, we adopted amendments to eliminate Regulation SHO's grandfather provision that allowed fails to deliver resulting from long or short sales of equity securities to persist indefinitely if the fails to deliver occurred prior to the security becoming a threshold security.[51] We believe that once a security becomes a threshold security, fails to deliver in that security must be closed out, regardless of whether or not the fails to deliver resulted from sales of the security in connection with the options or equities markets.

Moreover, we believe that fails to deliver resulting from hedging activities by options market makers should be treated similarly to fails to deliver resulting from sales in the equities markets so that market participants trading threshold securities in the options markets do not receive an advantage over those trading such securities in the equities markets. We are also concerned that the current options market maker exception might allow for a regulatory arbitrage not permitted in the equities markets. For example, an options market maker who sells short to hedge put options purchased by a market participant unable to locate shares for a short sale in accordance with Rule 203(b)(2) of Regulation SHO may not have to close out any fails to deliver that result from such short sales under the current options market maker exception. The ability of options market makers to sell short and never have to close out a resulting fail to deliver position, provided the short sale was effected to hedge options positions created before the security became a threshold security, runs counter to the goal of similar treatment for fails to deliver resulting from sales of securities in the options and equities markets, because

[50] *See, e.g.*, letter from Feeney, *supra* note 10.

[51] *See* Securities Exchange Act Release No. 56212 (Aug. 7, 2007); *see also*, 2006 Proposing Release, 71 FR at 41711–41712.

no such ability is available in the equity markets.[52]

Although commenters who opposed the proposed amendments to the options market maker exception favored maintaining Regulation SHO's current options market maker exception, it has become apparent to us during the comment process that the language of the current exception is being interpreted more broadly than the Commission intended, such that the exception seems to be operating significantly differently from our original expectations.[53] Thus, we are concerned that options market makers are claiming the exception even where options positions are created *after* the underlying security becomes a threshold security. For example, options market makers' practice of ''rolling'' positions from one expiration month to the next potentially allows these options market makers to not close out fail to deliver positions as required by the close-out requirements of Regulation SHO. According to commenters, when the options that allow an options market maker to be exempt from the close-out requirement expire or are closed out, investors on the opposite side may roll their long put or short call positions to a new expiration month.[54] It appears that options market makers are not treating the rolling of options positions to a new expiration month as creating new options positions for purposes of the current options market maker exception even though the current options position typically is closed out and the same position is opened in the next expiration month.[55]

Thus, options market makers providing liquidity to customers who are ''rolling'' positions from one expiration month to the next appear to use the original short sale to maintain the hedge on these new options positions, rather than closing out that original short sale and any fails to deliver that resulted from the short sale and establishing a new hedge. Regulation SHO's current options market maker exception provides that a fail to deliver position does not have to be closed out if it results from a short sale effected to establish or maintain a hedge on options positions created before the underlying security became a threshold security. Options market makers also may not be closing out fails to deliver that result from short sales effected to maintain or establish a hedge on options positions created *after* the underlying security became a threshold security. Such conduct would not be in compliance with the current options market maker exception and would allow options market makers to avoid improperly Regulation SHO's close-out requirement.[56]

In addition, as a practical matter, we note that the cost of maintaining a fail to deliver position may change over time and, in particular, when a security becomes a threshold security. Thus, if options market makers, in accommodating their customers' rolling of options positions from one expiration month to the next, use the original short sale to maintain the hedge on these new options positions rather than closing out that short sale and any fails to deliver that resulted from the short sale and establishing a new hedge, any additional cost of maintaining a fail to deliver in the underlying security would not be properly transferred to the options positions.

Despite our concerns noted above regarding the application of Regulation SHO's current options market maker exception, we credit commenters' statements that the amendments proposed in 2006 to narrow the current options market maker exception would be costly and difficult to implement, or even possibly unworkable, because they do not reflect how options market makers hedge their options positions. According to commenters, options market makers usually hedge their options positions on a portfolio basis.[57] Thus, an options market maker typically does not assign a particular short or long position to a particular options position as would be required if the Commission were to adopt the 2006 amendments, as proposed. Only one commenter asked that the Commission be sensitive to the time necessary to make systems changes to track the requirements of the proposed amendments.[58] Most commenters simply stated that the amendments proposed in 2006 would be difficult and costly to implement or possibly unworkable.

Based on commenters' concerns that they would be unable to comply with the amendments to the options market maker exception as proposed in the 2006 Proposing Release, and statements indicating that options market makers might be violating the current exception, we have determined to re-propose amendments to the options market maker exception.

III. Proposed Amendments to the Options Market Maker Exception

A. Elimination of the Options Market Maker Exception

We propose to eliminate the options market maker exception in Rule 203(b)(3) of Regulation SHO. In particular, the proposed amendment would require that any previously excepted fail to deliver position in a threshold security on the effective date of the amendment, including any adjustments to that fail to deliver position, be closed out within 35 consecutive settlement days[59] of the effective date of the amendment. This 35 consecutive settlement day requirement would be a one-time phase-in period. Thus, after 35 consecutive settlement days from the effective date of the amendment this phase-in period would expire and any additional fails to deliver in the threshold security would be subject to the current mandatory 13 consecutive settlement day close-out requirement of Rule 203(b)(3) of Regulation SHO.[60]

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[52] *See* Securities Exchange Act Release No. 56212 (Aug. 7, 2007).

[53] The Commission noted in the Adopting Release that it would monitor the operation of Regulation SHO and, in so doing, would take into consideration any indications that the options market maker exception was operating significantly differently from the Commission's original expectations. *See* Adopting Release, 69 FR at 48018–48019.

[54] *See, e.g.*, letters from ABA, *supra* note 31; Wolverine, *supra* note 31.

[55] *See, e.g.*, letter from Wolverine, *supra* note 31.

[56] In addition, we are concerned that options market makers may not have systems in place to determine whether or not fails to deliver resulted from short sales effected to establish or maintain a hedge on options positions created before or after the underlying security became a threshold security, and, therefore, may not be complying with the requirements of the current exception.

[57] *See, e.g.*, letters from CBOE, *supra* note 31; Options Exchanges, *supra* note 31; Wolverine, *supra* note 31; UBS, *supra* note 31; Angel, *supra* note 31.

[58] *See* letter from UBS, *supra* note 31.

[59] If the security is a threshold security on the effective date of the amendment, participants of a registered clearing agency would have to close out that position within 35 consecutive settlement days, regardless of whether the security becomes a non-threshold security after the effective date of the amendment.

We chose 35 settlement days because 35 days was used in Regulation SHO as adopted in August 2004, and in Regulation SHO, as amended. *See* Adopting Release, 69 FR at 48031; Securities Exchange Act Release No. 56212 (Aug. 7, 2007). In addition, we believe that 35 settlement days would allow participants time to close out their previously-excepted fail to deliver positions given that some participants may have large previously-excepted fails with respect to a number of securities.

[60] For example, assume that on the effective date of the amendment XYZ security is a threshold security and a participant of a registered clearing agency has fails to deliver in XYZ security that resulted from short sales by a registered options market maker to hedge options positions that were created before XYZ security became a threshold security. The participant must close out the fails to deliver in XYZ security within 35 consecutive settlement days of the effective date of the amendment, including any additional fails to deliver during that 35-day period that result from short sales by the registered options market maker to hedge options positions that were created before XYZ security became a threshold security. After the

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 from the effective date of the amendment, the proposed amendment 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. Any fails to deliver that were not previously-excepted from the close-out requirement of Rule 203(b)(3) of Regulation SHO as of the effective date of the amendment and, therefore, not subject to the one-time 35 consecutive settlement day phase-in period, would be subject to the pre-borrow requirement of Rule 203(b)(3)(iv) of Regulation SHO.

If a security becomes a threshold security after the effective date of the amendment, any fails to deliver that result or resulted from short sales effected by a registered options market maker to establish or maintain a hedge on options positions that were created before the security became a threshold security would be subject to Rule 203(b)(3)'s mandatory 13 consecutive settlement day close-out requirement, similar to any other fail to deliver position in a threshold security.

For the reasons discussed above and in the 2006 Proposing Release, we believe that no fail to deliver position should be left open indefinitely. Although we included in Rule 203 of Regulation SHO exceptions to the close-out requirement of the rule, we also stated that we would pay close attention to the operation and efficacy of the provisions adopted in Rule 203, and would consider whether any further action was warranted.[61] As discussed above, we continue to see a small number of threshold securities with large and persistent fails to deliver that are not being closed out under existing delivery and settlement requirements. We are concerned that these fails to deliver may have a potentially negative impact on the market for these securities by impeding the orderly functioning of the markets for these securities, depriving investors of ownership rights, undermining investor and issuer confidence in the markets, and being indicative of potentially manipulative trading activities. In addition, a seller that fails to deliver securities on trade settlement date effectively unilaterally converts a securities contract (that should settle within the standard 3-day settlement period) into an undated futures-type contract, to which the buyer might not have agreed, or that might have been priced differently.

Thus, by proposing to eliminate the current options market maker exception of Regulation SHO so that all fails to deliver in threshold securities that result from short sales effected to maintain or establish a hedge on options positions would have to be closed out within Regulation SHO's current mandatory 13 consecutive settlement day close-out requirement similar to all other fails to deliver in threshold securities, we hope to reduce the number of threshold securities with large and persistent fails to deliver and, thereby, limit any potential negative impact of such fails to deliver on the market for these securities.

In addition, the overly-broad interpretation of the current options market maker exception, as discussed above, could be contributing to some securities with listed options having large and persistent fails to deliver and remaining on the threshold securities list. Thus, we further believe it would be appropriate to eliminate the current exception.

By proposing to eliminate the current options market maker exception, fails to deliver from hedging activities by options market makers would be treated similarly to fails to deliver resulting from sales in the equities markets so that market participants trading threshold securities in the options market would not receive an advantage over those trading such securities in the equities markets.

In addition, we believe the proposed amendment would be warranted because it strikes the appropriate balance between reducing large and persistent fails to deliver in threshold securities while still allowing participants some flexibility in conducting their hedging activities. Under the proposed amendment, other than those previously-excepted fails to deliver that would be subject to the one-time 35-day phase-in period, all fails to deliver in threshold securities would be subject to the current mandatory 13 consecutive settlement day close-out requirement of Rule 203(b)(3) of Regulation SHO. Thus, the proposed amendment would provide flexibility because it would allow an extended period of time (*i.e.*, 13 consecutive settlement days) within which to close out all fails to deliver in threshold securities, rather than, for example, requiring that such fails to deliver be closed out immediately, or even within the standard 3-day settlement period. During the period of time that the fail to deliver position could remain open, options market makers would be able to continue any hedging activity without having to close out the fail to deliver position or pre-borrow to maintain the hedge.

In addition, we note that the one-time 35 consecutive settlement day phase-in period would help reduce any potential for market disruption, such as increased volatility or short squeezes, from having to close-out previously-excepted fail to deliver positions particularly as participants would be able to begin to close out such positions at anytime before the 35-day phase-in period.

Request for Comment

The Commission seeks comment generally on all aspects of this proposed amendment to Regulation SHO. In addition, we seek comment on the following:

- The proposed amendment to eliminate the options market maker exception would require that fails to deliver that result from short sales effected to maintain or establish a hedge on options positions be closed out within Regulation SHO's current mandatory 13 consecutive settlement day close-out requirement similar to other fails to deliver in any threshold security. We believe that fails to deliver in threshold securities should not last indefinitely. Thus, we proposed and adopted amendments to eliminate the grandfather provision in Regulation SHO so that fails to deliver resulting from long or short sales in the equities markets must be closed out within 13 consecutive settlement days. Should fails to deliver that result from short sales effected to maintain or establish a hedge on options positions be treated differently from fails to deliver that result from short or long sales of threshold securities in the equities markets? If so, why? Should market makers in the options markets be permitted to maintain a fail to deliver position in a threshold security for an extended period of time or indefinitely when market makers in the equities markets are not able to do so? If so, why? If not, why not?

35-day period has expired, if XYZ security remains a threshold security, any additional fails to deliver in XYZ security must be closed out in accordance with Regulation SHO's 13 consecutive settlement day close-out requirement, regardless of whether or not the fails to deliver resulted from short sales by a registered options market maker to hedge options positions that were created before XYZ security became a threshold security.

[61] *See* Adopting Release, 69 FR at 48019.

• The options market maker exception was created to provide options market makers with flexibility in establishing and maintaining hedges on options positions created before the underlying security became a threshold security. Would elimination of the options market maker exception be appropriate? If so, why? If not, why not? Would elimination of the options market maker exception result in fewer options on threshold securities and what effect would this have on market efficiency and capital formation? Would eliminating the exception reduce the willingness of options market makers to make markets in securities that might become threshold securities or that are threshold securities? Would eliminating the exception result in increased costs to investors? Would options investors bear any additional costs that are not borne by the equivalent equity investors? Would eliminating this exception reduce liquidity in securities that might become threshold securities or that are threshold securities? How significant would such an impact be, if any, given that fails to deliver would be subject to Regulation SHO's current 13 consecutive settlement days close-out requirement similar to all other fails to deliver in threshold securities and that we are not aware that compliance with the current mandatory close-out requirement of Regulation SHO for non-excepted fails to deliver has resulted in market disruption? What other measures or time-frames would be effective in fostering Regulation SHO's goal of reducing fails to deliver while at the same time allowing market making by options market makers?

• Based on current experience with Regulation SHO, what have been the costs and benefits of the current options market maker exception?

• What are the costs and benefits of the proposed amendment to eliminate the options market maker exception?

• What technical or operational challenges would options market makers face in complying with the proposed amendment?

• Would the proposed amendment create additional costs, such as costs associated with systems, surveillance, or recordkeeping modifications that may be needed for participants to track fails to deliver subject to the 35 consecutive settlement day phase-in period from fails to deliver that are not eligible for the phase-in period? If there are additional costs associated with tracking fails to deliver subject to the 35 versus 13 consecutive settlement day requirements, would these additional costs justify the benefits of providing firms with a 35 consecutive settlement day phase-in period? Would a 35 consecutive settlement day phase-in period be necessary given that firms would have been on notice that they would have to close out these fail to deliver positions following the effective date of the amendment?

• Should we consider changing the proposed phase-in period to 35 calendar days? If not, why not? If so, would this create systems problems or other costs? Would a phase-in period create examination or surveillance difficulties?

• Please provide specific comment as to what length of implementation period would be necessary such that participants would be able to meet the requirements that fail to deliver positions in threshold securities be closed out within the applicable time-frames, if adopted.

B. Alternatives To Eliminating the Options Market Maker Exception

As discussed above, due to the fact that large and persistent fails to deliver are not being closed out under existing delivery and settlement requirements and because we are concerned that these fails to deliver may have a negative impact on the market for those securities, we believe that the options market maker exception to the mandatory close-out requirement of Rule 203(b)(3) of Regulation SHO should be eliminated. In addition, we believe that the options market maker exception should be eliminated because we believe that fails to deliver resulting from hedging activities by options market makers should be treated similarly to fails to deliver resulting from sales in the equities markets so that market participants trading threshold securities in the options markets do not receive an advantage over those trading such securities in the equities market.

We anticipate, however, that in response to our request for comment on the proposed amendments to eliminate the options market maker exception, we will receive comment that an options market maker exception, similar to the current exception in Regulation SHO, is necessary. It has become apparent to us, however, that the current exception is being interpreted in such a way that the exception seems to be operating significantly differently from our original expectations, and that options market makers might be using the current exception to improperly avoid closing out certain fails to deliver in threshold securities. In addition, commenters stated that the proposed amendments to the options market maker exception set forth in the 2006 Proposing Release would be impractical given the industry practice of using hedges to manage the risk of an entire inventory, not just a specific options position.[62] Thus, in conjunction with our proposal to eliminate the options market maker exception, we have determined to solicit comment regarding two narrowly-tailored alternatives to the current options market maker exception and to our proposed elimination of that exception.

Because we are concerned that any exception to Regulation SHO's close-out requirement for fails to deliver resulting from short sales effected to establish or maintain a hedge on options positions might result in continued large and persistent fails to deliver in securities with options traded on them, the proposed alternatives would provide very limited exceptions to the close-out requirement of Regulation SHO so that all fails to deliver in threshold securities underlying options would eventually have to be closed out. Similar to elimination of the options market maker exception, by proposing to require that all fails to deliver be closed out within specific time-frames, the proposed alternatives should reduce large and persistent fails to deliver. The proposed alternatives, however, would provide participants of a registered clearing agency, or options market makers for which they clear transactions, longer periods of time than Regulation SHO's current mandatory 13 consecutive settlement day close-out requirement, within which to close out such fails to deliver.

Also, similar to the proposed amendment to eliminate the options market maker exception, by proposing to require that fails to deliver be closed out within specific time-frames, the proposed alternatives would be more likely to result in shareholders receiving the benefits of ownership than under the current options market maker exception. Sellers would also be less able to unilaterally convert securities contracts into undated futures-type contracts to which the buyer may not have agreed, or that would have been priced differently. In addition, the delivery requirements of the proposed alternatives could enhance investor confidence as they make investment decisions by providing investors with greater assurance that securities would be delivered as expected. An increase in investor confidence in the market could facilitate investment.

The proposed alternatives could benefit issuers because investors may be

[62] *See, e.g.*, letters from CBOE, *supra* note 31; CTC LLC, *supra* note 31; Citigroup, *supra* note 31; Wolverine, *supra* note 31.

more willing to commit capital where fails levels are lower. In addition, some issuers could believe that a reduction in fails to deliver could reverse unwarranted reputational damage potentially caused by large and persistent fails to deliver and what they believe might be an indication of manipulative trading activities, such as ''naked'' short selling.[63] Thus, the proposed requirement that all fails to deliver be closed out within specific time-frames, as proposed to be required by the alternatives, could decrease the possibility of artificial market influences and, therefore, could contribute to price efficiency.

Although the proposed alternatives could lessen the potential negative impact of large and persistent fails to deliver similar to the proposed elimination of the options market maker exception because the proposed alternatives would require that fails to deliver in threshold securities eventually be closed out, we believe that complete elimination of the options market maker exception would achieve this goal more effectively. Under the proposed elimination of the options market maker exception, all fails to deliver in threshold securities would have to be closed out within Regulation SHO's mandatory 13 consecutive settlement day close-out requirement. The proposed alternatives, however, would each allow a longer period of time for fail to deliver positions to be closed out. Specifically, the first alternative would allow certain fails to deliver to be closed out within 35 consecutive settlement days of the security becoming a threshold security. Under the second alternative, although some fails to deliver would be required to be closed out in less than 35 consecutive settlement days, other fails to deliver would not have be closed out until 35 consecutive settlement days from the security becoming a threshold security.

Similar to our discussions above in connection with our response to comments regarding the proposed amendment in the 2006 Proposing Release to limit the duration of the current options market maker exception and regarding the proposed amendment to eliminate the options market maker exception, we believe the mandatory close-out requirements of each of the proposed alternatives would similarly minimally impact, if at all, liquidity, hedging costs, spreads, or depth in the securities subject to the close-out requirements of the proposed alternatives, or the willingness of options market makers to make markets in such securities.

We believe that these potential effects of the close-out requirements of the proposed alternatives would be minimal, if any, because the number of securities that would be impacted by the close-requirements would be relatively small. The proposed alternatives would apply only to those threshold securities with listed options[64] and would only impact fails to deliver in those securities that resulted from short sales by registered options market makers to hedge options series that were created before, rather than after, the security became a threshold security because all other fails to deliver in threshold securities are subject to Regulation SHO's current mandatory 13 consecutive settlement day close-out requirement.

In addition, the proposed alternatives would provide options market makers with flexibility in conducting their hedging activities because they would each allow an extended period of time (*i.e.*, 35 consecutive settlement days for purposes of proposed Alternative 1 and 13 or 35 consecutive settlement days for purposes of proposed Alternative 2) within which to close out all fails to deliver in threshold securities. As discussed above in connection with the proposed amendment to eliminate the options market maker exception, we believe that even a 13 consecutive settlement day close-out requirement would result in minimal impact on the willingness of options market makers to make markets, liquidity, hedging costs, depth, and spreads because it would allow options market makers flexibility in conducting their hedging activities by permitting fails to deliver to remain open for an extended period of time (*i.e.*, 13 consecutive settlement days) rather than, for example, requiring that such fails to deliver be closed out immediately, or even within the standard 3-day settlement period. During the period of time that the fail to deliver position can remain open, options market makers would be able to continue any hedging activity without having to close out the fail to deliver position or pre-borrow to maintain the hedge.

The extended close-out requirements of the proposed alternatives would expire, however, after 35 consecutive settlement days of the security becoming a threshold security. In each of the proposed alternatives, after the excepted period expires, any additional fails to deliver that result from short sales in the threshold security, whether or not effected to establish or maintain a hedge on options series in the portfolio that were created before the security became a threshold security, would have to be closed within Rule 203(b)(3)'s mandatory 13 consecutive settlement day close-out requirement.

The proposed alternatives are narrowly tailored in response to our concerns that options market makers are interpreting the current exception more broadly than the Commission intended and in response to comments that options market makers manage their risk based on an assessment of the entire portfolio rather than of a specific options position. Based on comments that portfolio hedging is the industry practice, the proposed alternatives refer to the hedging of options series in a portfolio rather than an options position. In addition, the proposed alternatives would permit options market makers to adjust their hedges on options series created before the underlying security became a threshold security provided any resulting fails to deliver are closed out within the applicable time-frames.

The proposed alternatives would also require that participants of a registered clearing agency and options market makers document that any fails to deliver in threshold securities that have not been closed out in accordance with the 13 consecutive settlement days close-out requirement of Rule 203(b)(3) of Regulation SHO are eligible for the options market maker exception.[65] The current exception does not set forth a specific documentation requirement, although some options market makers may in fact keep records that relate to their compliance with the exception. In the absence of such a requirement, we are concerned that many options market makers are not preparing or retaining records with regard to their eligibility for the exception. Without such a documentation requirement, it may be difficult for the Commission and SROs to monitor whether the options market maker exception is being applied consistently with the rule.

Thus, to the extent we retain an options market maker exception, we believe it would be necessary to add a provision to Regulation SHO that would

[63] *See, e.g., supra* note 8 (citing to comment letters from issuers and investors discussing extended fails to deliver in connection with ''naked'' short selling).

[64] *See* letter from Options Exchanges, *supra* note 49 (discussing the number of threshold securities with listed options).

[65] Commenters to the 2006 Proposing Release urged the Commission to add specific documentation requirements for establishing eligibility for the options market maker exception. *See, e.g.,* letters from NASAA, *supra* note 31; TASER, supra note 8.

require both options market makers and participants of a registered clearing agency that rely on the options market maker exception to not close out a fail to deliver position in accordance with the mandatory close-out requirement of Rule 203(b)(3) of Regulation SHO to obtain, prepare, and keep documentation demonstrating that a fail to deliver position has not been closed out because it qualified for the exception. Such documentation could indicate, among other things, when the series being hedged was created, when the underlying security became a threshold security, and the age of the fail to deliver position that is not being closed out.

A documentation requirement would enable the Commission and the SROs to monitor more effectively whether or not the options market maker exception is being applied correctly. In addition, the information would provide a record that would aid surveillance for compliance with this limited exception to Regulation SHO's close-out requirement.

The Alternatives

We are requesting comment regarding specific alternatives, as described below, to eliminating the options market maker exception. Each of the proposed alternatives would provide for a 35 consecutive settlement day phase-in period similar to the phase-in period discussed above for securities that are threshold securities on the effective date of the amendment and that have previously excepted fail to deliver positions.[66] In addition, as explained in more detail below, these alternatives would apply only to fails to deliver resulting from short sales effected by a registered options market maker to establish or maintain a hedge on any options series created before an underlying security became a threshold security. These alternatives would also require such fails to deliver to be closed out within specific time-frames so that the fails to deliver would not last indefinitely.

i. Alternative 1

We request comment regarding an options market maker exception that would require a participant of a registered clearing agency that has a fail to deliver position in a threshold security that results or resulted from a short sale by a registered options market maker to establish or maintain a 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. After the 35 consecutive settlement days has expired, any additional fails to deliver would be subject to the mandatory 13 consecutive settlement day close-out requirement of Rule 203(b)(3) of Regulation SHO.

We propose 35 consecutive settlement days for purposes of proposed Alternative 1 because 35 days was used in Regulation SHO as adopted in August 2004, and in Regulation SHO, as amended and, therefore, is a period of time with which market participants subject to Regulation SHO are familiar.[67] In addition, because we believe that all fails to deliver should be closed out within specific time-frames we did not want to propose an alternative that would allow fails to deliver to continue indefinitely, or for a period of time that would undermine the goal of requiring that all fails to deliver be closed out within a reasonable time period. We believe that 35 consecutive settlement days would allow participants time to close out their excepted fail to deliver positions without extending the close-out requirement beyond what we believe would be a reasonable period of time within which fails to deliver should be closed out.

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.

Example: The following is an example of how proposed Alternative 1 would work if it were effective in February. XYZ security becomes a threshold security in March. On the date on which XYZ security becomes a threshold security, a participant of a registered clearing agency has fails to deliver in XYZ security that resulted from short sales by a registered options market maker to hedge options series in XYZ portfolio that were created before XYZ security became a threshold security. The participant must close out the entire fail to deliver position in XYZ security, including any additional fails that result from short sales to hedge options series in XYZ portfolio that were created before XYZ security became a threshold security, within 35 consecutive settlement days of the date on which XYZ security became a threshold security in March. After the 35 consecutive settlement days, any additional fails to deliver in XYZ security, whether or not they result or resulted from short sales by a registered options market maker to hedge options series in XYZ portfolio that were created before XYZ security became a threshold security, must be closed out in accordance with Regulation SHO's mandatory 13 consecutive settlement day close-out requirement.

ii. Alternative 2

As another alternative to eliminating the options market maker exception, we request comment regarding a proposed options market maker exception that would require a participant of a registered clearing agency that has a fail to deliver position in a threshold security that results or resulted from a short sale by a registered options market maker to establish or maintain a hedge on any options series in 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 the earlier of: (i) 35 Consecutive settlement days from the date on which the security became a threshold security, or (ii) 13 consecutive settlement days from the last date on which all options series within the portfolio that were created before the security became a threshold security expire or are liquidated. After the 35 or 13 consecutive settlement days has expired, any additional fails to deliver would be subject to the mandatory 13 consecutive settlement day close-out requirement of Rule 203(b)(3) of Regulation SHO.

We propose to require in Alternative 2 that fails to deliver be closed out within 13 consecutive settlement days if all options series within the portfolio that were created before the security became a threshold security expire or are liquidated because, at that point, there would be nothing in the portfolio for the original short sale and resulting fail to deliver position to hedge. We chose a proposed close-out requirement of 13 consecutive settlement days for such situations because it is a time-frame currently used in the mandatory close-out requirement of Rule 203(b)(3) of Regulation SHO[68] and, therefore, is a time-frame with which market

[66] This 35 consecutive settlement day phase-in period would operate in the same manner as that outlined above in the discussion of the elimination of the options market maker exception.

[67] *See* Adopting Release, 69 FR at 48031; Securities Exchange Act Release No. 56212 (Aug. 7, 2007).

[68] *See* 17 CFR 242.203(b)(3).

participants subject to the close-out requirement of Regulation SHO are currently familiar and with which such entities appear able to comply.

In addition, as discussed above for proposed Alternative 1, we chose 35 consecutive settlement days for purposes of proposed Alternative 2 because this is also a time-frame already used in Regulation SHO as adopted in August 2004, and in Regulation SHO, as amended and, therefore, is a time-frame with which market participants subject to Regulation SHO are already familiar.[69] In addition, because we believe that all fails to deliver should be closed out within specific time-frames we did not want to propose an alternative that would allow fails to deliver to continue indefinitely, or for a period of time that would undermine the goal of requiring that all fails to deliver be closed out within a reasonable time period. We believe that a close-out requirement that provides that fails to deliver must be closed out within the time-frames specified by proposed Alternative 2 would allow participants time to close out their excepted fail to deliver positions without extending the close-out requirement beyond what we believe would be a reasonable period of time within which fails to deliver should be closed out.

In addition, similar to the pre-borrow requirement of Rule 203(b)(3)(iv) of Regulation SHO, if the excepted fail to deliver position has persisted for longer than the earlier of: (i) 35 Consecutive settlement days from the date on which the security became a threshold security, or (ii) 13 consecutive settlement days from the last date on which all options series within the portfolio that were created before the security became a threshold security expire or are liquidated, the proposal 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 excepted fail to deliver position by purchasing securities of like kind and quantity.

Example 1. The following is an example of how proposed Alternative 2 would work if it were effective in February. XYZ security becomes a threshold security in March. On the date on which XYZ security becomes a threshold security, a participant of a registered clearing agency has fails to deliver in XYZ security that resulted from short sales by a registered options market maker to hedge its XYZ portfolio that were created before XYZ security became a threshold security. On the date on which XYZ security becomes a threshold security, XYZ portfolio consists of XYZ April 50 Calls and XYZ July 50 Calls. The last date on which the options within XYZ portfolio expire is July, which is later than 35 consecutive settlement days from the date on which XYZ security became a threshold security. In addition, none of the options series within XYZ portfolio have been exercised. Thus, the participant must close out the entire fail to deliver position in XYZ security, including any additional fails that result from short sales to hedge options series in XYZ portfolio that were created before XYZ security became a threshold security, within 35 consecutive settlement days of the date on which XYZ security became a threshold security in March. After the 35 consecutive settlement days, any additional fails to deliver in XYZ security, whether or not they result or resulted from short sales by a registered options market maker to hedge options series in XYZ portfolio that were created before XYZ security became a threshold security, must be closed out in accordance with Regulation SHO's mandatory 13 consecutive settlement day close-out requirement.

Example 2. The following is another example of how proposed Alternative 2 would work if it were effective in February. XYZ security becomes a threshold security in March. On the date on which XYZ security becomes a threshold security, a participant of a registered clearing agency has fails to deliver in XYZ security that resulted from short sales by a registered options market maker to hedge options series in its XYZ portfolio that were created before XYZ security became a threshold security. On the date on which XYZ security becomes a threshold security, XYZ portfolio consists of XYZ April 50 Calls and XYZ July 50 Calls. Options market maker firm exercises both call options in March, shortly after XYZ security became a threshold security. Because options market maker firm liquidated the entire XYZ portfolio prior to the expiration of 35 consecutive settlement days from the date on which XYZ security became a threshold security, or the last expiration date for the options comprising the XYZ portfolio, the participant must close out the entire fail to deliver position in XYZ security, including any additional fails to deliver that result from short sales by a registered options market maker to hedge options series in XYZ portfolio that were created before XYZ security became a threshold security, within 13 consecutive settlement days of the date on which the options series within XYZ portfolio were exercised.

Request for Comment

The Commission seeks comment generally on all aspects of the proposed alternatives to elimination of the options market maker exception. In addition, we seek comment on the following:

- As set forth in proposed Alternative 1, should participants of a registered clearing agency, or options market makers that have been allocated the close-out requirement under Regulation SHO, have a limited exception to the close-out requirement that would allow 35 consecutive settlement days from the security becoming a threshold security for the fail to deliver position to be closed out? If so, why? If not, why not? Alternatively, as set forth in proposed Alternative 2, should the limited exception allow the earlier of: (i) 35 Consecutive settlement days from the date on which the security becomes a threshold security, or (ii) 13 consecutive settlement days from the last date on which all options series within the portfolio that were created before the security became a threshold security expire or are liquidated, for the fail to deliver position to be closed out? If so, why?
- In our discussion above regarding the impact of the proposed amendment to eliminate Regulation SHO's current options market maker exception on liquidity, spreads, depth, and hedging costs, we stated that we believe that such an impact would be minimal, if any. For similar reasons, we believe that the impact of the mandatory close-out requirements in the proposed alternatives on liquidity, spreads, depth, and hedging costs would be minimal, if any. To what extent would an options market maker exception as set forth in the proposed alternatives, rather than eliminating the exception, impact liquidity in securities that might become threshold securities or in threshold securities? To what extent would an options market maker exception as set forth in the proposed alternatives, rather than eliminating the exception, impact the willingness of options market makers to make markets in securities that might become threshold securities or in threshold securities? What other measures or time-frames would be effective in fostering Regulation SHO's goal of reducing fails to deliver while at the same time not discouraging market making by options market makers?
- In the proposed alternatives to eliminating the options market maker exception, fails to deliver would only be excepted from the close out requirement of Regulation SHO if the fail to deliver position results or resulted from a short sale effected to establish or maintain a hedge on options series created before the security became a threshold security. Is the reference to ''options series'' appropriate? Please explain.

[69] *See* Adopting Release, 69 FR at 48031; Securities Exchange Act Release No. 56212 (Aug. 7, 2007).

• Are the terms ''expiration'' and ''liquidation'' of an options series sufficiently inclusive to prevent participants from evading the close-out requirements in the proposed alternatives? Are these terms understandable for compliance purposes? If not, what terms would be more appropriate? What difficulties, if any, could arise from having to determine the last date on which all options series within a portfolio that were created before the security became a threshold securities have expired or been liquidated?

• We provide examples of how the proposed alternatives would be applied. We request comment regarding these examples, and suggestions regarding additional examples that would be helpful in understanding how the proposed alternatives would work that could be incorporated by the Commission into any future releases, if the Commission were to adopt either of the proposed alternatives.

• What types of costs would be incurred in complying with the proposed alternatives? For example, what types of costs, if any, could be incurred for tracking the 35 or 13 consecutive settlement day close-out requirements? What types of costs, if any, could be incurred in determining whether or not options series were created before the security became a threshold security? What types of costs could be incurred in determining whether or not a fail to deliver position resulted from a short sale to establish or maintain a hedge on options series created before the security became a threshold security? How would these costs differ from costs incurred to comply with the current options market maker exception in Regulation SHO? Would the costs relating to the alternative proposals justify the benefits of allowing for a limited exception to the close-out requirement for options market makers?

• What would be the costs and benefits of the proposed alternatives to eliminating the options market maker exception?

• Under the proposed alternatives, after the specific time-frames have expired, fails to deliver would be required to be closed out in compliance with the 13 consecutive settlement day close-out requirement of Rule 203(b)(3) of Regulation SHO regardless of whether or not the fails to deliver result or resulted from short sales effected by a registered options market maker to establish or maintain a hedge on options series created before the security became a threshold security. Under the proposed alternatives, might an options market maker need to maintain such fail to deliver positions beyond the 13 consecutive settlement days allowed by the close-out requirement of Rule 203(b)(3) of Regulation SHO? What might be the impact, if any, of requiring such fails to deliver to be closed out?

• What technical or operational challenges would options market makers face in complying with the proposed alternatives?

• Should we consider changing the proposed alternatives to 35 calendar days from the date on which the security becomes a threshold security? If so, would this create systems problems or other costs?

• The proposed alternatives would require that options market makers document eligibility for the exception. What should options market makers and participants of a registered clearing agency be required to include in the documentation? Should we specify in detail what would be required to be retained? For example, should we require that such documentation include, at a minimum, documentation evidencing when the series being hedged was created, when the underlying security became a threshold security, and the age of the fail to deliver position that is not being closed out?

• The proposed alternatives would require that participants of a registered clearing agency maintain documentation to demonstrate that a fail to deliver position has not been closed out due to the options market maker exception. Would this documentation requirement raise compliance concerns or any other concerns for participants? If so, please explain.

• The proposed alternatives would allow for a 35 consecutive settlement day phase-in period for previously excepted fails to deliver to be closed out. Is 35 consecutive settlement days from the effective date of the amendment a long enough period of time, or too long, for fails to deliver that were previously excepted from the close-out requirement of Regulation SHO to be closed out? If so, what would be an appropriate period of time?

• Would the proposed phase-in period create additional costs, such as costs associated with systems, surveillance, or recordkeeping modifications that could be needed for participants to track fails to deliver subject to the 35 consecutive settlement day phase-in period from fails to deliver that are not eligible for the phase-in period? If there were additional costs associated with tracking fails to deliver subject to the phase-in period, would these additional costs justify the benefits of providing firms with a 35 consecutive settlement day phase-in period? Is a 35 consecutive settlement day phase-in period necessary given that firms would have been on notice that they would have to close out these fail to deliver positions following the effective date of the amendment? Please provide estimates of these costs.

• Please provide specific comment as to what length of implementation period would be necessary such that participants would be able to meet the requirements that fail to deliver positions in threshold securities be closed out within the applicable time-frames, if adopted.

IV. Proposed Amendment to Rule 200(g)(1) of Regulation SHO

We are proposing an amendment to the long sale marking provisions of Rule 200(g)(1) of Regulation SHO that would require that brokers-dealers marking orders as ''long'' sales document the present location of the securities.

Prior to the adoption of Regulation SHO in August 2004, broker-dealers that were members of the NASD were obligated to comply with former NASD Rule 3370(b). Former NASD Rule 3370(b) required a broker-dealer making an affirmative determination that a customer was long to notate on the order ticket at the time an order was taken, the conversation with the customer as to the present location of the securities, whether they were in good deliverable form, and the customer's ability to deliver them to the member within three business days.[70]

Regulation SHO does not contain a similar provision to former NASD Rule 3370(b) regarding documentation of long sales.[71] Rule 200(g)(1) of

[70] NASD repealed NASD Rule 3370(b), the ''affirmative determination'' for long sales, following the adoption of Regulation SHO. The repeal of NASD Rule 3370(b) was effective on January 3, 2005, the effective date of Regulation SHO. *See* NASD Notice to Members 04–93. *See also,* Securities Exchange Act Release No. 50822 (Dec. 8, 2004), 69 FR 74554 (Dec. 14, 2004).

[71] Because Regulation SHO does not include a similar provision to former NASD Rule 3370(b) regarding documentation of long sales, on July 20, 2005, the NASD filed with the Commission, pursuant to Section 19(b)(3)(A) of the Exchange Act, a rule filing to amend NASD Rule 3370 to clarify that members must make an affirmative determination and document compliance when effecting long sale orders. In the filing, the NASD stated that it proposed to amend NASD Rule 3370 ''to re-adopt expressly the affirmative determination requirements as they now relate to member obligations with respect to long sales under Regulation SHO.'' The NASD designated the rule change as ''non-controversial.'' In response to the proposed rule change, the Commission received three comment letters, the substance of which called into question the ''non-controversial'' designation of the proposal. The Commission found that it was appropriate in the public interest, for the

Regulation SHO, however, provides that a broker-dealer may mark an order to sell ''long'' only if the seller is deemed to own the security being sold pursuant to paragraphs (a) through (f) of Rule 200,[72] and either the security is in the physical possession or control of the broker or dealer or it is reasonably expected that the security will be in the physical possession or control of the broker or dealer no later than the settlement of the transaction.[73] Thus, in marking a sell order ''long,'' a broker-dealer must determine whether the customer is ''deemed to own'' the securities being sold.

In the 2006 Proposing Release we requested comment regarding whether we should consider amending Regulation SHO to include documentation requirements for long sales similar to those required by former NASD Rule 3370(b).[74] We received approximately 8 comment letters in response to the request for comment.[75]

Commenters that supported documentation requirements for long sales argued that the ''volume of outstanding fails is too large to permit the execution of trades where there is doubt about delivery.'' [76] Commenters opposing documentation requirements for long sales stated that pre-trade documentation would unnecessarily impair efficiency, as broker-dealers already have procedures to ensure orders are marked properly based on information provided by customers and their own books and records, and the documentation requirements would add substantial cost.[77] One commenter stated that compliance with such pre-trade documentation requirements would require a complete revamping of front end systems.[78] Another commenter stated that the requirements would be inconsistent with the goal of fostering liquidity.[79]

Commenters also argued that the Commission has not presented evidence that long sales are contributing to a troublesome level of fails [80] or abusive or manipulative activity,[81] and that lack of documentation is related to those fails.[82] One commenter stated that there is no valid purpose to put this additional burden on the industry.[83] Another commenter argued that requiring this additional documentation should be considered only where the benefits clearly outweigh the burdens.[84] Commenters also suggested that if the Commission did adopt additional long sale documentation requirements, it should except prime broker and DVP trades, ''done with'' trades, and orders submitted electronically,[85] or where settlement instructions are on file with the executing broker.[86]

Although some commenters stated that pre-trade documentation for long sales would be inconsistent with the goal of fostering liquidity, would unnecessarily impair efficiency, and would add substantial cost,[87] we believe that such costs, to the extent that there are any, would be justified by the benefits of a documentation requirement, as described below. In addition, we note that under former NASD Rule 3370(b), NASD member firms making an affirmative determination that a customer was long were required to make a notation on the order ticket at the time an order was taken which reflected the conversation with the customer as to the present location of the securities, whether they were in good deliverable form, and the customer's ability to deliver them to the member within three business days.[88] Thus, many broker-dealers should already be familiar with a documentation requirement and one method that could be used to comply with such a requirement. Such familiarity should help reduce any costs associated with implementing the proposed documentation requirement. In addition, unlike with former NASD Rule 3370(b), the proposed amendment would not specify the format or methodology of the proposed documentation requirement. The absence of such specifications should help reduce costs to broker-dealers that would have to comply with this proposal because broker-dealers would be able to determine the most cost effective format and methodology for meeting the proposed documentation requirement.

We are proposing for further comment a documentation requirement for broker-dealers marking orders to sell ''long'' pursuant to Regulation SHO that would require such broker-dealers to document the present location of the securities being sold. First, we believe that such a proposed documentation requirement would aid in ensuring the correct marking of sell orders. To the extent that the seller is unable to provide the present location of the securities being sold, the broker-dealer

protection of investors, and otherwise in furtherance of the purposes of the Exchange Act, to abrogate the proposed rule change. *See* Securities Exchange Act Release No. 52426 (Sept. 14, 2005); Securities Exchange Act Release No. 52131 (July 27, 2005), 70 FR 44707 (Aug. 3, 2005). The NASD took no further action with respect to the proposed rule change.

[72] Rule 200(a) defines the term ''short sale,'' while Rules 200(b) through 200(f) set forth circumstances in which a seller is deemed to own securities. *See* 17 CFR 242.200(a)–(f).

[73] 17 CFR 242.200(g)(1).

[74] *See* 2006 Proposing Release, 71 FR at 41714. Specifically we stated: ''Current Rule 203(a) provides that on a long sale, a broker-dealer cannot fail or loan shares unless, in advance of the sale, it has demonstrated that it has ascertained that the customer owned the shares, and had been reasonably informed that the seller would deliver the security prior to settlement of the transaction. Former NASD Rule 3370 required that a broker making an affirmative determination that a customer was long must make a notation on the order ticket at the time an order was taken which reflected the conversation with the customer as to the present location of the securities, whether they were in good deliverable form, and the customer's ability to deliver them to the member within three business days. Should we consider amending Regulation SHO to include these additional documentation requirements? If so, should any modifications be made to these additional requirements? In the prior SRO rules, brokers did not have to document long sales if the securities were on deposit in good deliverable form with certain depositories, if instructions had been forwarded to the depository to deliver the securities against payment (''DVP trades''). Under Regulation SHO, a broker may not lend or arrange to lend, or fail, on any security marked long unless, among other things, the broker knows or has been reasonably informed by the seller that the seller owns the security and that the seller would deliver the security prior to settlement and failed to do so. Is it generally reasonable for a broker to believe that a DVP trade will settle on time? Should we consider including or specifically excluding an exception for DVP trades or other trades on any rule requiring documentation of long sales?''

[75] *See, e.g.*, letters from NASAA, *supra* note 31; UBS, *supra* note 31; SIA, *supra* note 31. *See also,* letter from Leonard J. Amoruso, Compliance and Regulatory Affairs, Knight Capital Group, Inc., dated Sept. 20, 2006 (''Knight''); letter from John G. Gaine, President, Managed Funds Association, dated Sept. 19, 2006 (''MFA''); letter from Martin Schwartz, Chief Compliance Officer, Millennium Partners, LP, Oct. 10, 2006 (''Millennium''); letter from Susan Trimbath, Ph.D., CEO and Chief Economist, STP Advisory Services, LLC, Aug. 29, 2006 (''Trimbath''); letter from Wayne Klein, Director, Division of Securities, State of Utah Department of Commerce, Sept. 13, 2006 (''Utah Department of Commerce'').

[76] *See, e.g.*, Letters from NASAA, *supra* note 31; Utah Department of Commerce, *supra* note 75.

[77] *See* letters from MFA, *supra* note 75; UBS, *supra* note 31; Knight, *supra* note 75.

[78] *See* letter from SIA, *supra* note 31.

[79] *See* letter from Millennium, *supra* note 75.

[80] *See* letter from MFA, *supra* note 75. *See also,* letter from Millennium, *supra* note 75.

[81] *See* letter from SIA, *supra* note 31 .

[82] *See* letter from MFA, *supra* note 75.

[83] *See* letter from UBS, *supra* note 31.

[84] *See* letter from MFA, *supra* note 75.

[85] *See* letters from SIA, *supra* note 31; Knight, *supra* note 75. The SIA commented that ''a broker-dealer should be provided an exception from such long sale annotation requirements if the broker-dealer has information regarding the client's custodial relationship. Providing such an exception would be consistent with the Commission's long-standing policy of allowing broker-dealers to enter into bona-fide agreements with their customers regarding marking of orders.'' *See* letter from SIA, *supra* note 31.

[86] *See* letter from Knight, *supra* note 75.

[87] *See, e.g.*, letters from MFA, *supra* note 75; UBS, *supra* note 31; Knight, *supra* note 75; SIA, *supra* note 31; Millenium, *supra* note 75.

[88] Brokers and dealers that were members of the NASD were obligated to comply with former NASD Rule 3370(b) prior to the adoption of Regulation SHO.

would have reason to believe that the seller is not ''deemed to own'' the securities being sold and that the securities would not be in its physical possession or control no later than settlement of the transaction and, therefore, that the broker-dealer would be required to mark the sale ''short'' rather than ''long.'' [89] We believe that this proposed documentation requirement could also reduce the number of fails to deliver because, after making the inquiry into the present location of the securities being sold, a broker-dealer would know whether or not it needed to obtain securities for delivery.

Second, we are concerned that broker-dealers marking orders ''long'' may not be making a determination prior to marking the order that the seller is ''deemed to own'' the security being sold.[90] Rule 200(g)(1) currently requires that broker-dealers ascertain whether the customer is ''deemed to own'' the securities being sold before marking a sell order ''long.'' [91] We believe that a proposed documentation requirement would help ensure that the broker-dealer marking the sale ''long'' has inquired into, and determined that, the seller is ''deemed to own'' the securities being sold because the broker-dealer would be required to document the present location of the securities being sold.

Third, we believe that the proposed documentation requirement would enable the Commission and SROs to examine for compliance with the long sale marking provisions of Rule 200(g) more effectively because this proposed documentation requirement would provide a record that the seller is ''deemed to own'' the securities being sold in compliance with that rule. We also believe that the proposed documentation requirement would aid the Commission and SROs in reviewing for mismarking designed to avoid compliance with other rules and regulations of the federal securities laws, such as the ''locate'' requirement of Regulation SHO,[92] and Rule 105 of Regulation M.[93]

We believe that any costs that would arise from the proposed requirement that a broker-dealer must document the present location of securities being sold long when making the determination that a customer is deemed to own the securities being sold would be minimal because Rule 200(g)(1) currently requires that broker-dealers must ascertain whether the customer is ''deemed to own'' the securities being sold before marking a sell order ''long.'' [94] Today's proposed amendment would require that the broker-dealer take the additional step of documenting the present location of the securities being sold. Broker-dealers could, however, need to put mechanisms in place to facilitate efficient documenting of the information required by the proposed amendment.

Request for Comment

The Commission seeks comment generally on all aspects of the proposed amendment to Rule 200(g) of Regulation SHO. In addition, we seek comment on the following:

- Is the proposed documentation requirement appropriate? If not, why not?
- Commenters that responded to the request for comment regarding documentation of long sales in the 2006 Proposing Release stated that market participants already have in place procedures to ensure that orders to sell shares are properly marked. What are those procedures and how do they ensure that orders are properly marked? How do broker-dealers currently comply with the ''deemed to own'' requirement of Rule 200(g)(1) of Regulation SHO?
- One commenter that responded to the request for comment regarding documentation of long sales in the 2006 Proposing Release stated that the requirement would be inconsistent with the goal of fostering liquidity.[95] To what extent, if any, would the proposed amendment impact liquidity in securities being sold long? Please explain.
- The ''locate'' requirement of Rule 203(b)(1) of Regulation SHO contains an exception for market makers. Should market makers also have an exception for the proposed long sale documentation requirement? Please explain.
- Should we specify the proposed format of the documentation? Should the proposed documentation be on the order ticket or elsewhere? Please provide recommended alternatives and estimates of the costs of various alternatives.
- Under what circumstances, if any, should we allow the documentation to be generated post-trade?
- In addition to proposing documentation of the present location of the securities being sold, should we require additional documentation requirements to those proposed, such as requiring broker-dealers to make a record reflecting the basis for believing that the securities are in good deliverable form, and the basis for believing that the securities will be in the broker-dealer's possession or control no later than settlement of the transaction?
- The Commission has previously stated that it may be unreasonable for a broker-dealer to treat a sale as long where orders marked ''long'' from the same customer repeatedly require borrowed shares for delivery or result in fails to deliver.[96] A broker-dealer also may not treat a sale as long if the broker-dealer knows or has reason to know that the customer borrowed the shares being sold.[97] Should broker-dealers be required to take additional steps to determine whether or not the seller is deemed to own the securities being sold in conjunction with documenting the present location of the securities?
- The proposed amendment would impose an obligation on broker-dealers to inquire into the present location of securities being sold and to document that location. To what extent would this proposed requirement impact the accuracy of marking by broker-dealers? To what extent would this proposed requirement impact the level of fails to

[89] *See* 17 CFR 242.200(g).

[90] *See id.* at 242.200(g)(1).

[91] In the Adopting Release, we stated that ''* * * Rule 203(a) provides that on a long sale, a broker-dealer cannot fail or loan shares unless, in advance of the sale, it ascertained that the customer owned the shares, and had been reasonably informed that the seller would deliver the security prior to settlement of the transaction. This requirement is consistent with changes being made to the order marking requirements, which require that for an order to be marked long, the seller must own the security.'' *See* Adopting Release, 69 FR at 48021.

[92] *See* 17 CFR 242.203(b)(1). Rule 203(b)(1) of Regulation SHO provides that ''[a] broker or dealer may not accept a short sale order in an equity security from another person, or effect a short sale in an equity security for its own account, unless the broker or dealer has: (i) Borrowed the security, or entered into a bona fide arrangement to borrow the security; or (ii) Reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due * * *.'' This provision is commonly referred to as the ''locate'' requirement.

[93] *See* 17 CFR 242.105 (prohibiting persons from covering a short sale with offering securities if the short sale occurred during the Rule 105 restricted period). *See also, In the Matter of Goldman Sachs Execution & Clearing, L.P. f/k/a Spear, Leeds, & Kellogg, L.P.*, Securities Exchange Act Release No. 55465 (Mar. 14, 2007), Admin. Proc. File No. 3–12590 (settling enforcement proceedings against a prime broker and clearing affiliate of The Goldman Sachs Group, Inc., Goldman Sachs Execution and Clearing L.P., for its violations arising from an illegal trading scheme carried out by customers through their accounts at the firm, which included the mismarking of sell orders as ''long.'').

[94] *See* 17 CFR 242.200(g).

[95] *See* letter from Millennium, *supra* note 75.

[96] *See* Adopting Release, 69 FR at 48019, n.111.

[97] *See id.*

deliver in a security, such as fails to deliver due to mismarking? To what extent would this proposed requirement impact compliance with other short sale-related regulations, such as the locate requirement of Regulation SHO and Rule 105 of Regulation M?

• Should any trades be excepted from the proposed documentation requirement? For example, under former NASD Rule 3370(b) broker-dealers did not have to document long sales if the securities were on deposit in good deliverable form with certain depositories, if instructions had been forwarded to the depository to deliver the securities against payment (''DVP trades''). Should we consider including or specifically excluding an exception for DVP trades? Should any other trades be specifically included or excluded from the proposed documentation requirement?

• Former NASD Rule 3370(b) required broker-dealers making an affirmative determination that a customer was long to make a notation on the order ticket at the time an order was taken regarding the conversation with the customer as to the present location of the securities, whether they were in good deliverable form, and the customer's ability to deliver them to the member within three business days. The proposed amendment would require broker-dealers to document only the present location of the securities being sold long. To what extent would the requirements of the proposed amendment impose costs, such as personnel, systems, or surveillance costs on market participants that are any different from such costs imposed on market participants to comply with former NASD Rule 3370(b)?

• Most broker-dealers allow investors to submit orders electronically. Do these systems automatically verify the location of shares for long sales before routing the orders for execution? If so, how much would it cost for broker-dealers to adjust their systems to record the location of the securities being sold on the trade record? If not, what changes would the proposed documentation requirement require and how much would it cost for broker-dealers to adjust their systems to verify and document the location of the shares for long sales? To what extent do investors communicate order requests via other means, such as by telephone or in person? How do the costs of the proposed documentation requirement differ for these order requests versus electronic order submissions?

• Some investors have direct access to alternative trading systems. Are alternative trading systems already programmed to verify the location of the shares in orders marked as long sales? If not, to what extent, if any, should alternative trading systems be responsible for meeting this requirement? How much would it cost?

• Some broker-dealers sponsor direct access to exchanges for preferred clients. To what extent do these broker-dealers currently document the location of shares for long sales that their clients send directly to exchanges? What costs are associated with such documentation?

• Do algorithmic trading systems [98] present any problems for compliance with the proposed amendment? Are there any other current market practices that present problems for compliance with documentation requirements?

V. General Request for Comment

The Commission seeks comment generally on all aspects of the proposed amendments to Regulation SHO under the Exchange Act, including the proposed alternatives to the proposal to eliminate the options market maker exception. Commenters are requested to provide empirical data to support their views and arguments related to the proposals herein. In addition to the questions posed above, commenters are welcome to offer their views on any other matter raised by the proposed amendments to Regulation SHO. With respect to any comments, we note that they are of the greatest assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments and if accompanied by alternative suggestions to our proposals where appropriate.

VI. Paperwork Reduction Act

Certain provisions of the proposed amendments to Regulation SHO would impose new ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (''PRA'') [99] which the Commission has submitted to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. OMB has not yet assigned a control number to the new collection of information.

A. Summary of Collections of Information

The proposed amendment to eliminate the options market maker exception to the close-out requirement of Regulation SHO would not impose a new ''collection of information'' within the meaning of the PRA. The two proposed alternatives to elimination of the options market maker exception and the proposed amendment to Rule 200(g) of Regulation SHO would impose a new ''collection of information'' within the meaning of the PRA.

i. Proposed Alternatives to Elimination of the Options Market Maker Exception

The proposed alternatives to elimination of the options market maker exception would both require that options market makers and participants of a registered clearing agency document that any fail to deliver positions that have not been closed out are excepted from the close-out requirement of Regulation SHO because the fails to deliver resulted from short sales effected by a registered options market maker to establish or maintain a hedge on options series in a portfolio that were created before the security became a threshold security. This would be a new collection of information because Regulation SHO does not currently require documentation to show eligibility for the options market maker exception.

ii. Proposed Amendment to Rule 200(g)(1)

The proposed amendment to Rule 200(g)(1) of Regulation SHO would require that brokers and dealers marking orders as ''long'' sales document the present location of the securities.

Under Rule 200(g)(1), a broker-dealer may mark an order to sell ''long'' only if the seller is deemed to own the security being sold pursuant to paragraphs (a) through (f) of Rule 200,[100] and either the security is in the physical possession or control of the broker or dealer or it is reasonably expected that the security will be in the physical possession or control of the broker or dealer no later than the settlement of the transaction.[101] Thus, in marking a sell order ''long,'' a broker or dealer must determine whether the customer is ''deemed to own'' the securities being sold.

This would be a new collection of information because Regulation SHO

[98] An algorithmic trading program detects trading opportunities for the strategies input by investors and responds to them by placing and managing orders on behalf of those investors.

[99] 44 U.S.C. 3501 *et seq.*

[100] Rule 200(a) defines the term ''short sale,'' while Rules 200(b) through 200(f) set forth circumstances in which a seller is deemed to own securities. *See* 17 CFR 242.200(a)–(f).

[101] 17 CFR 242.200(g)(1).

does not currently require documentation by brokers and dealers when marking sell orders as ''long.''

B. Proposed Use of Information

i. Proposed Alternatives to Elimination of the Options Market Maker Exception

The information that would be required by the proposed alternatives to elimination of the options market maker exception would assist the Commission in fulfilling its mandate under the Exchange Act to prevent fraudulent, manipulative, and deceptive acts and practices. The Commission and SROs would use the information collected to monitor whether or not the options market maker exception to the close-out requirement of Regulation SHO is being applied consistently with the rule. The information required by the proposed amendment would provide a record that would aid surveillance for compliance with this limited exception to Regulation SHO's close-out requirement.

ii. Proposed Amendment to Rule 200(g)(1)

The information that would be required by the proposed amendment to Rule 200(g)(1) would assist the Commission in fulfilling its mandate under the Exchange Act to prevent fraudulent, manipulative, and deceptive acts and practices. Such a documentation requirement would aid in ensuring the correct marking of sell orders. To the extent that the seller is unable to provide the present location of the securities being sold, the broker-dealer would have reason to believe that the seller is not ''deemed to own'' the securities being sold and that the securities would not be in its physical possession or control no later than settlement of the transaction and, therefore, that the broker-dealer would be required to mark the sale ''short'' rather than ''long.'' [102] We believe that this documentation requirement could also reduce the number of fails to deliver because, after making the inquiry into the present location of the securities being sold, a broker-dealer would know whether or not it needed to obtain securities for delivery.

In addition, we are concerned that broker-dealers marking orders ''long'' may not be making a determination prior to marking the order that the seller is ''deemed to own'' the security being sold. Rule 200(g)(1) currently requires that broker-dealers ascertain whether the customer is ''deemed to own'' the securities being sold before marking a sell order ''long.'' [103] We believe that a documentation requirement would help ensure that the broker-dealer marking the sale ''long'' has inquired into, and determined that, the seller is ''deemed to own'' the securities being sold because the broker-dealer would be required to document the present location of the securities being sold.

We also believe that the documentation requirement would enable the Commission and SROs to examine for compliance with the long sale marking provisions of Rule 200(g) more effectively because this documentation requirement would provide a record that the seller is ''deemed to own'' the securities being sold in compliance with that rule. We also believe that the documentation requirement would aid the Commission and SROs in reviewing for mismarking designed to avoid compliance with other rules and regulations of the federal securities laws, such as the ''locate'' requirement of Regulation SHO,[104] and Rule 105 of Regulation M.[105]

C. Respondents

i. Proposed Alternatives to Elimination of the Options Market Maker Exception

The documentation requirement of the proposed alternatives to elimination of the options market maker exception would apply to all participants of a registered clearing agency and options market makers who have not closed out a fail to deliver position in a threshold security because it resulted from short sales effected by the registered options market maker to establish or maintain a hedge on options series in a portfolio that were created before the security became a threshold security.

ii. Proposed Amendment to Rule 200(g)(1)

The proposed amendment to Rule 200(g)(1) of Regulation SHO would require that brokers and dealers marking orders as ''long'' sales document the present location of the securities. Thus, the amendment would apply to all brokers-dealers registered with the Commission as they could all execute long sales. The Commission's Office of Economic Analysis (''OEA'') estimates that at year-end 2006 there are approximately 5,808 active brokers-dealers registered with the Commission.[106]

D. Total Annual and Recordkeeping Burdens

i. Proposed Alternatives to Elimination of the Options Market Maker Exception

The proposed alternatives to elimination of the options market maker exception would require that options market makers and participants of a registered clearing agency document that any fail to deliver positions that have not been closed out are excepted from the close-out requirement of Regulation SHO because the fails to deliver resulted from short sales effected by a registered options market maker to establish or maintain a hedge on options series in a portfolio that were created before the security became a threshold security.

We estimate that it would take an options market maker no more than approximately 0.16 hours (10 minutes) to document that a fail to deliver position has not been closed out due to its eligibility for the options market maker exception.[107] We understand that eligibility for the options market maker exception would likely be determined on a daily basis, rather than on a trade by trade basis. Based on data from the first quarter of 2006,[108] for purposes of this PRA, we estimate that, on average, there would be approximately 75 securities each day that are (i) on a threshold securities list, and (ii) have open interest in exchange traded options. On average, we estimate there would be approximately 5 options market makers engaged in delta hedging these options.[109] Thus, we estimate that on average, options market makers would have to document compliance with the proposed alternatives to the elimination of the options market maker exception 94,500 times per year (5 options market makers checking for compliance once per day on 75 securities, multiplied by 252 trading

[102] *See id.*

[103] *See id.*

[104] *See supra* note 92.

[105] *See supra* note 93.

[106] This number is based on OEA's review of 2006 FOCUS Report filings reflecting registered brokers-dealers. This number does not include broker-dealers that are delinquent with FOCUS Report filings.

[107] We do not believe that the documentation requirement is complex. We understand that options market makers receive daily trading reports from NSCC reflecting an options market maker's trading activity for that day. Options market makers should be able to use such information to document eligibility for the exception from the close-out requirement of Regulation SHO. Because options market makers receive these daily trading reports, we estimate that it would take an options market maker no more than approximately 10 minutes to document that a fail to deliver position has not been closed out due to its eligibility for the options market maker exception.

[108] We used the first quarter of 2006 because this is the most recent period over which we have access to option open interest data.

[109] This estimate is based on there being 5 options exchanges that have a specialist or specialist-like structure and an estimation that each exchange would have 1 options market maker actively engaged in hedging threshold securities with listed options.

days in a year). Thus, the total approximate estimated annual burden hour per year would be 15,120 burden hours (94,500 @ 0.16 hours/documentation). A reasonable estimate for the paperwork compliance for the proposed alternatives for each options market maker would be approximately 3,024 burden hours (18,900 instances of documentation per respondent @ 0.16 hours/documentation).

We estimate that it would take a participant of a registered clearing agency no more than approximately 0.16 hours (10 minutes) to document that a fail to deliver position has not been closed out due to its eligibility for the options market maker exception.[110] If a participant of a registered clearing agency had a fail to deliver position in a threshold security and after twelve consecutive settlement days the participant determined whether or not the fail to deliver position was excepted from Regulation SHO's close-out requirement due to hedging activity by a registered options market maker, we estimate that a participant of a registered clearing agency would have to make such determination with respect to approximately three threshold securities per day.[111] We understand that there are currently approximately sixteen participants of a registered clearing agency that clear transactions for options market makers.[112] Thus, we estimate that on average, a participant of a registered clearing agency would have to document compliance with the proposed alternatives to the elimination of the options market maker exception 12,096 times per year (16 participants checking for compliance once per day on three securities, multiplied by 252 trading days in a year). Thus, the total approximate estimated annual burden hour per year would be approximately 1,935 burden hours (12,096 @ 0.16 hours/documentation). A reasonable estimate for the paperwork compliance for the proposed alternatives for each participant would be approximately 120 burden hours (756 instances of documentation per respondent @ 0.16 hours/documentation).

ii. Proposed Amendment to Rule 200(g)(1)

The proposed amendment to Rule 200(g)(1) of Regulation SHO would require that brokers and dealers marking orders as ''long'' sales document the present location of the securities. We estimate that all of the approximately 5,808 registered broker-dealers may effect sell orders in securities covered by Regulation SHO and, therefore, would be required to comply with the proposed documentation requirement.

For purposes of the PRA, OEA has estimated that a total of 2,750,000,000 trades are executed annually.[113] Of these 2,750,000,000 trades, OEA estimates that approximately 75%, that is, 2,062,500,000, of these trades would be ''long'' sales.[114] This would be an average of approximately 355,114 annual long sales by each respondent. In addition, because we believe that the documentation process is or will be automated, we estimate that it would take a registered broker-dealer approximately 0.000139 hours (0.5 seconds) to document the present location of the securities being sold.[115]

Thus, the total approximate estimated annual burden hour per year would be 286,688 burden hours (2,062,500,000 trades @ 0.000139 hours/trade). A reasonable estimate for the paperwork compliance for the proposed amendment for each broker-dealer would be approximately 49 burden hours (355,114 trades per respondent @ 0.000139 hours/response).

To the extent that broker-dealers need to automate the documentation process, we anticipate that such broker-dealers would spend varying amounts of time reprogramming systems, integrating systems, and potentially updating front-end software. Some broker-dealers may spend very little time automating the documentation process, while changes at other broker-dealers might be more involved. On average, we estimate that reprogramming burdens at a broker-dealer would be approximately 16 hours (or two days) with one programmer.[116] If broker-dealers hired new computer programmers at $67/hour, this would cost $1,072 per broker-dealer (16 hours @ $67 per hour) or an aggregate of $6,226,176 across all broker-dealers.[117]

E. Collection of Information is Mandatory

i. Proposed Alternatives to Elimination of the Options Market Maker Exception

The proposed collection of information for the proposed alternatives to elimination of the options market maker exception would be mandatory for a participant of a registered clearing agency and options market maker where a fail to deliver position has not been closed out because the fails to deliver resulted from short sales effected by a registered options market maker to establish or maintain a hedge on options series in a portfolio that were created before the security became a threshold security.

ii. Proposed Amendment to Rule 200(g)(1)

The proposed collection of information would be mandatory for a

[110] We do not believe that the documentation requirement is complex. Such documentation requirement could involve a participant of a registered clearing agency contacting a registered options market maker for which it clears transactions to determine whether or not trading activity by the registered options market maker was responsible for the fail to deliver position and whether or not the fail to deliver position resulted from short sales effected by the registered options market maker to establish or maintain a hedge on options series in a portfolio that were created before the security became a threshold security. After making such determination, the proposed amendment would require that the participant document this information. We estimate that such procedures would take a participant of a registered clearing agency no more than approximately 10 minutes to complete.

[111] We estimated that a participant would make such a determination for approximately 3 threshold securities per day based on data from the first quarter of 2006. We used the first quarter of 2006 because this is the most recent period over which we have access to option open interest data.

[112] This number is based on information received from the Options Clearing Corporation.

[113] In calendar year 2006, there were approximately 2.099 billion trades in NYSE and Nasdaq-listed stocks. In addition, there were approximately 2.114 billion trades in over-the-counter bulletin board (''OTCBB'') traded stocks. OEA estimates that if we were to include Amex-listed and pink sheet stocks, the total annual trades would be approximately 2.75 billion trades.

[114] *See* Office of Economic Analysis U.S. Securities and Exchange Commission, *Economic Analysis of the Short Sale Price Restrictions Under the Regulation SHO Pilot* (Sept. 14, 2006), available at *http://www.sec.gov/about/economic/shopilot091506/draft_reg_sho_pilot_report.pdf.*

[115] In the 2003 Proposing Release, we stated that we thought it was reasonable that it would only take 0.5 seconds or 0.000139 hours to mark an order ''long,'' ''short,'' or ''short exempt.'' *See* 2003 Proposing Release, 68 FR at 63000. We believe it is reasonable that it would take a similar amount of time to document the present location of the securities being sold, if the documentation process were automated. In addition, we note that Regulation SHO requires broker-dealers executing short sales to document compliance with the ''locate'' requirements of Rule 203(b)(1) of Regulation SHO, *i.e.*, prior to accepting or effecting a short sale in an equity security, a broker-dealer must document that it has (i) borrowed the security, or entered into a bona-fide arrangement to borrow the security, or (ii) reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due. Thus, broker-dealers should already have in place systems similar to those necessary to document the present location of the securities being sold for purposes of long sales.

[116] We believe that most of the relevant information is already stored in electronic form and, therefore, we do not believe that the automation process would be difficult or time-consuming to implement. Hence, we estimate that automation would on average take no longer than approximately 16 hours (2 days) to complete.

[117] The $67/hour figure for a computer programmer is based on the salary for a Senior Computer Operator from the SIA *Report on Office Salaries in the Securities Industry 2006*, modified to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead.

broker-dealer marking a sell order as ''long'' pursuant to Rule 200(g)(1).

F. Confidentiality

i. Proposed Alternatives to Elimination of the Options Market Maker Exception

The proposed collection of information for the proposed alternatives to elimination of the options market maker exception would be retained by participants of a registered clearing agency and options market makers and provided to the Commission and SRO examiners upon request, but not subject to public availability.

ii. Proposed Amendment to Rule 200(g)(1)

The proposed collection of information under the proposed amendment to Rule 200(g)(1) would be retained by the broker-dealer and provided to the Commission and SRO examiners upon request, but would not be subject to public availability.

G. Record Retention Period

i. Proposed Alternatives to Elimination of the Options Market Maker Exception

The proposed alternatives to elimination of the options market maker exception do not contain any new record retention requirements. All registered broker-dealers that would be subject to the proposed alternatives are currently required to retain records in accordance with Rule 17a–4 of the Exchange Act.[118]

As discussed above, participants of a registered clearing agency include entities not registered as broker-dealers, such as banks, U.S. exchanges, and clearing agencies.[119] Although we do not believe that participants of a registered clearing agency other than broker-dealers would trigger the obligations of the proposed alternatives, all banks subject to the proposed alternatives would be required to retain records in compliance with any existing or future record retention requirements established by the banking agencies. All U.S. exchanges and clearing agencies subject to the proposed alternatives would be required to retain records in compliance with Rule 17a–1 of the Exchange Act.[120]

ii. Proposed Amendment to Rule 200(g)(1)

The proposed amendment to Rule 200(g)(1) does not contain any new record retention requirements. All registered broker-dealers that would be subject to the proposed amendment are currently required to retain records in accordance with Rule 17a–4 of the Exchange Act.[121]

H. Request for Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to: (i) Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information shall have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collection of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) evaluate whether there are ways to minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090, with reference to File No. S7–19–07. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, with reference to File No. S7–19–07, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 100 F Street, NE., Washington, DC 20549–1090. As OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

VII. Consideration of Costs and Benefits of Proposed Amendments to Regulation SHO

The Commission is considering the costs and the benefits of the proposed amendments to Regulation SHO. The Commission is sensitive to these costs and benefits, and encourages commenters to discuss any additional costs or benefits beyond those discussed here, as well as any reductions in costs. In particular, the Commission requests comment on the potential costs for any modification to both computer systems and surveillance mechanisms and for information gathering, management, and recordkeeping systems or procedures, as well as any potential benefits resulting from the proposals for registrants, issuers, investors, brokers or dealers, other securities industry professionals, regulators, and other market participants. Commenters should provide analysis and data to support their views on the costs and benefits associated with the proposed amendments to Regulation SHO.

A. Elimination of the Options Market Maker Exception

1. Benefits

The proposed amendment would eliminate the options market maker exception in Rule 203(b)(3)(iii) of Regulation SHO. In particular, as a transition measure, the proposal would require that any previously-excepted fail to deliver position in a threshold security on the effective date of the amendment be closed out within 35 consecutive settlement days of the effective date of the amendment. If a security becomes a threshold security after the effective date of the amendment, any fails to deliver that result or resulted from short sales effected by a registered options market maker to establish or maintain a hedge on any options positions created before the security became a threshold security would be subject to Rule 203(b)(3)'s mandatory 13 consecutive settlement day close-out requirement, similar to any other fail to deliver position in a threshold security.

On July 14, 2006, the Commission published proposed amendments to the options market maker exception contained in Regulation SHO to limit the duration of the exception.[122] We proposed to narrow the options market maker exception at that time because we have observed a small number of threshold securities with substantial and persistent fail to deliver positions that are not being closed out under existing delivery and settlement guidelines and we believed that these persistent fail to deliver positions were attributable, in part, to the options market maker exception in Regulation SHO.[123]

As a result of the comment process, however, we learned that commenters were concerned that the proposed

[118] 17 CFR 240.17a–4.

[119] *See supra* note 22.

[120] 17 CFR 240.17a–1.

[121] *Id.* at 240.17a–4.

[122] *See* 2006 Proposing Release, 71 FR 41710.

[123] *See id.* at 41712; Regulation SHO Re-Opening Release, 72 FR at 15079–15080.

amendments to the options market maker exception could be costly and difficult to implement or possibly unworkable because options market makers typically use hedges to manage the risk of an entire inventory, not just a specific options position.

We remain concerned that large and persistent fails to deliver are not being closed out due to the options market maker exception in Regulation SHO and that these fails to deliver may have a negative effect on the market in these securities. For example, large and persistent fails to deliver may deprive shareholders of the benefits of ownership, such as voting and lending. In addition, where a seller of securities fails to deliver securities on trade settlement date, in effect the seller unilaterally converts a securities contract (which should settle within the standard 3-day settlement period) into an undated futures-type contract, to which the buyer may not have agreed, or that would have been priced differently. Moreover, sellers that fail to deliver securities on settlement date may enjoy fewer restrictions than if they were required to deliver the securities within a reasonable period of time, and such sellers may attempt to use this additional freedom to engage in trading activities that deliberately depress the price of a security.

In addition, many issuers and investors continue to express concern about extended fails to deliver in connection with ''naked'' short selling.[124] To the extent that large and persistent fails to deliver may be indicative of manipulative ''naked'' short selling, which could be used as a tool to drive down a company's stock price, fails to deliver may undermine the confidence of investors.[125] These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to such manipulative conduct.[126] In addition, issuers may believe that they have suffered unwarranted reputational damage due to investors' negative perceptions regarding large and persistent fails to deliver.[127] Thus, large and persistent fails to deliver may result in an increase in artificial market influences on a security's price.[128]

Also, as part of the comment process to the proposed amendments to the options market maker exception as set forth in the 2006 Proposing Release, some commenters' statements indicated to us that the current options market maker exception might not be sufficiently narrowly tailored to limit the extent to which options market makers can claim an exception to the close-out requirement of Regulation SHO. Thus, we determined to re-propose amendments to the options market maker exception that would eliminate the exception and, thereby, reduce the number of large and persistent fails to deliver in threshold securities.

Consistent with the Commission's investor protection mandate, the proposed amendment would benefit investors by facilitating the receipt of shares so that more investors receive the benefits associated with share ownership, such as the use of the shares for voting and lending purposes. The proposal could enhance investor confidence as they make investment decisions by providing investors with greater assurance that securities would be delivered as expected. An increase in investor confidence in the market could facilitate investment.

The proposed amendment should also benefit issuers. A high level of persistent fails to deliver in a security could be perceived by potential investors negatively and could affect their decision about making a capital commitment.[129] Some issuers could believe that they have endured unwarranted reputational damage due to investors' negative perceptions regarding a security having a large fail to deliver position and becoming a threshold security.[130] Thus, issuers could believe the elimination of the options market maker exception would restore their good name. Some issuers could also believe that large and persistent fails to deliver indicate that they have been the target of potentially manipulative conduct as a result of ''naked'' short selling.[131] Thus, elimination of the options market maker could decrease the possibility of artificial market influences and, therefore, could contribute to price efficiency.

We solicit comment on any additional benefits that could be realized with the proposed amendment, including both short-term and long-term benefits. We solicit comment regarding other benefits to market efficiency, pricing efficiency, market stability, market integrity, and investor protection.

2. Costs

To comply with Regulation SHO when it became effective in January 2005, market participants needed to modify their recordkeeping systems and surveillance mechanisms. In addition, market participants should have retained and trained the necessary personnel to ensure compliance with the rule. Thus, the infrastructure necessary to comply with the proposed amendment should already be in place because the proposed amendment, if adopted, would require that all fails to deliver be closed out in accordance with the 13 consecutive settlement day mandatory close-out requirement of Regulation SHO. The only fails to deliver not subject to Regulation SHO's mandatory close-out requirement would be those fails to deliver that would be previously-excepted from the close-out requirement and, therefore, eligible for the one-time 35 day phase-in period of the proposed amendment. Thus, any changes to personnel, computer hardware and software, recordkeeping or surveillance costs should be minimal.

In the 2006 Proposing Release we requested comment regarding the costs of the proposed amendments to the options market maker exception and how those costs would affect liquidity in the options markets. Commenters who opposed the proposal to narrow the options market maker exception stated that the amendments would disrupt the markets because they would not provide sufficient flexibility to permit efficient hedging by options market makers, would unnecessarily increase risks and costs to hedge, and would adversely impact liquidity and result in higher costs to customers.[132] These commenters stated that they believe the proposed amendments would likely discourage options market makers from making markets in illiquid securities since the risk associated in maintaining the hedges in these option positions would be too great.[133] Moreover, these

[124] *See, e.g.,* supra note 8 (citing to comment letters from issuers and investors discussing extended fails to deliver in connection with ''naked'' short selling).

[125] *See, e.g., supra* note 9 (citing to comment letters discussing the impact of fails to deliver on investor confidence).

[126] *See, e.g., supra* note 10 (citing to comment letters expressing concern regarding the impact of potential ''naked'' short selling on capital formation).

[127] *See supra* note 11.

[128] *See also,* 2006 Proposing Release, 71 FR at 41712 (discussing the impact of large and persistent fails to deliver on the market). *See also,* 2003 Proposing Release, 68 FR at 62975 (discussing the impact of ''naked'' short selling on the market).

[129] *See, e.g., supra* note 10 (citing to comment letters expressing concern regarding the impact of potential ''naked'' short selling on capital formation).

[130] *See, e.g., supra* note 11.

[131] *See, e.g., supra* note 8 (citing to comment letters from issuers and investors discussing extended fails to deliver in connection with ''naked'' short selling).

[132] *See, e.g.,* letter from CBOE, *supra* note 31.

[133] *See id.*

commenters stated that the reluctance of options market makers to make markets in threshold securities would result in wider spreads in such securities to account for the increased costs of hedging, to the detriment of investors.[134]

Although we recognize commenters' concerns that a mandatory close-out requirement for fails to deliver in threshold securities underlying options positions could potentially impact options market makers' willingness to provide liquidity in threshold securities, make it more costly for options market makers to accommodate customer buy orders, or result in wider bid-ask spreads or less depth, for the reasons discussed below, we believe that such an impact, if any, would be minimal.

First, we believe that the potential effects, if any, of a mandatory close-out requirement would be minimal because the number of securities that would be impacted by a mandatory close-out requirement would be small. Regulation SHO's close-out requirement is narrowly tailored in that it targets only those securities where the level of fails to deliver is high (0.5% of total shares outstanding and 10,000 shares or more) for a continuous period (five consecutive settlement days).[135] Requiring close out only for securities with large and persistent fails to deliver limits the overall market impact. In addition, as noted by one commenter, a small number of securities that meet the definition of a ''threshold security'' have listed options, and those securities form a very small percentage of all securities that have options traded on them.[136] Moreover, the current options market maker exception only excepts from Regulation SHO's mandatory 13 consecutive settlement day close-out requirement those fail to deliver positions that result from short sales effected by registered options market makers to establish or maintain a hedge on options positions established *before* the underlying security became a threshold security. Thus, it does not apply to fails to deliver resulting from short sales effected to establish or maintain a hedge on options positions established *after* the underlying security became a threshold security. Because the current options market maker exception has a very limited application, the overall impact of its removal on liquidity, hedging costs, spreads, and depth should be relatively small.

Second, to the extent that a mandatory close-out requirement could potentially impact options market makers' willingness to provide liquidity in threshold securities, make it more costly for options market makers to accommodate customer buy orders, or result in wider bid-ask spreads or less depth, we believe that any such potential effects would likely be mitigated by the fact that even though fails to deliver that were previously-excepted from the close-out requirement of Regulation SHO would not be permitted to continue indefinitely, such fails to deliver would not have to be closed out immediately, or even within the standard 3-day settlement period. Instead, under Rule 203(b)(3)'s 13 consecutive settlement day close-out requirement, fails to deliver in threshold securities would have an extended period of time within which to be closed out. An extended close-out requirement would provide options market makers with some flexibility in conducting their hedging activities in that it would allow them to not close out a fail to deliver position or pre-borrow to maintain a hedge in a threshold security for 13 consecutive settlement days.

Third, as noted above, Regulation SHO's current options market maker exception is limited to only those fail to deliver positions that result from short sales effected by registered options market makers to establish or maintain a hedge on options positions established *before* the underlying security became a threshold security. Thus, it does not apply to fails to deliver resulting from short sales effected to establish or maintain a hedge on options positions established *after* the underlying security became a threshold security. In evaluating the application of the current mandatory close-out requirement of Regulation SHO for all non-excepted fail to deliver positions, we have not become aware of any evidence that the current close-out requirement for non-excepted fails to deliver in threshold securities has impacted options market makers' willingness to provide liquidity in threshold securities, made it more costly for options market makers to accommodate customer orders, or resulted in wider bid-ask spreads or less depth. Similarly, all fails to deliver in threshold securities resulting from long or short sales of securities in the equities markets must be closed out in accordance with Regulation SHO's mandatory 13 consecutive settlement day close-out requirement, and we are not aware that such a requirement has impacted the willingness of market makers to make markets in securities subject to the close-out requirement, or led to decreased liquidity, wider spreads, or less depth in these securities. Thus, we believe that the impact of requiring that fails to deliver in threshold securities resulting from short sales to hedge options positions created before the security became a threshold security be closed out would similarly be minimal, if any.

Fourth, to the extent that a mandatory close-out requirement for all fails to deliver resulting from hedging activity in the options markets could potentially impact liquidity, hedging costs, depth, or spreads, or impact the willingness of options market makers to make a market in certain securities, we believe that such effects are justified by our belief, as discussed in more detail below, that fails to deliver resulting from hedging activities by options market makers should be treated similarly to fails to deliver resulting from sales in the equities markets so that market participants trading threshold securities in the options markets do not receive an advantage over those trading such securities in the equities markets.

Fifth, to the extent that a mandatory close-out requirement for all fails to deliver resulting from hedging activity in the options markets could potentially impact liquidity, hedging costs, depth, or spreads, or impact the willingness of options market makers to make a market in certain securities, we believe that these potential effects are justified by the benefits of requiring that fails to deliver in all threshold securities be closed out within specific time-frames rather than being allowed to continue indefinitely. As discussed above, large and persistent fails to deliver can deprive shareholders of the benefits of ownership, such as voting and lending. They can also be indicative of potentially manipulative conduct, such as abusive ''naked'' short selling. The deprivation of the benefits of ownership, as well as the perception that abusive ''naked'' short selling is occurring in certain securities, can undermine the confidence of investors. These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to manipulative conduct.

In the 2006 Proposing Release, we sought comment on whether the proposed amendments would promote capital formation, including whether the proposed increased short sale restrictions would affect investors' decisions to invest in certain equity securities. Commenters expressed concern about ''naked'' short selling

[134] *See* letter from Citigroup, *supra* note 31.

[135] *See supra* note 7 (discussing the number of threshold securities as of March 31, 2007).

[136] *See* letter from Options Exchanges, *supra* note 49.

causing a drop in an issuer's stock price and that it may limit an issuer's ability to access the capital markets.[137] We believe that, by requiring that all fails to deliver in threshold securities be closed out within specific time-frames rather than allowing them to continue indefinitely, there would be a decrease in the number of threshold securities with persistent and high levels of fails to deliver. If persistence on the threshold securities lists leads to an unwarranted decline in investor confidence about the security, the proposed amendments should improve investor confidence about the security. We also believe that the proposed amendments should lead to greater certainty in the settlement of securities which should strengthen investor confidence in the settlement process.

Due to our concerns about the potentially negative market impact of large and persistent fails to deliver, and the fact that we continue to observe a small number of threshold securities with fail to deliver positions that are not being closed out under existing delivery and settlement requirements, we adopted amendments to eliminate Regulation SHO's grandfather provision that allowed fails to deliver resulting from long or short sales of equity securities to persist indefinitely if the fails to deliver occurred prior to the security becoming a threshold security.[138] We believe that once a security becomes a threshold security, fails to deliver in that security must be closed out, regardless of whether or not the fails to deliver resulted from sales of the security in connection with the options or equities markets.

Moreover, we believe that fails to deliver resulting from hedging activities by options market makers should be treated similarly to fails to deliver resulting from sales in the equities markets so that market participants trading threshold securities in the options markets do not receive an advantage over those trading such securities in the equities markets. We are also concerned that the current options market maker exception might allow for a regulatory arbitrage not permitted in the equities markets. For example, an options market maker who sells short to hedge put options purchased by a market participant unable to locate shares for a short sale in accordance with Rule 203(b)(2) of Regulation SHO may not have to close out any fails to deliver that result from such short sales under the current options market maker exception. The ability of options market makers to sell short and never have to close out a resulting fail to deliver position, provided the short sale was effected to hedge options positions created before the security became a threshold security, runs counter to the goal of similar treatment for fails to deliver resulting from sales of securities in the options and equities markets, because no such ability is available in the equity markets.[139]

In addition, we believe the proposed 35 consecutive settlement day phase-in period should not result in market disruption, such as increased volatility or short squeezes, because it would provide time for participants of a registered clearing agency, or options market makers for which they clear transactions, to close out previously-excepted fail to deliver positions in an orderly manner, particularly because participants and options market makers could begin closing out previously-excepted fail to deliver positions at any time before the proposed 35 day phase-in period. The 35 day phase-in period may result in some systems and surveillance-related costs, but these costs should be one-time rather than ongoing costs because the phase-in period would expire 35 settlement days after the effective date of the proposed amendment, if adopted.

Also, the proposed pre-borrow requirement for fail to deliver positions that are not closed out within the applicable time-frames set forth in the proposed amendment would result in limited, if any, costs to participants of a registered clearing agency, and options market makers for which they clear transactions. The proposed pre-borrow requirement is similar to the pre-borrow requirement of Rule 203(b)(3)(iii) of Regulation SHO, as originally adopted. Thus, participants of a registered clearing agency, and any options market maker for which it clears transactions, must already comply with such a requirement if a fail to deliver position has not been closed out in accordance with Regulation SHO's mandatory close-out requirement. Accordingly, these entities should already have in place the personnel, recordkeeping, systems, and surveillance mechanisms necessary to comply with the proposed pre-borrow requirement.

We seek comment about any other costs and cost reductions associated with the proposed amendment or alternative suggestions. Specifically:

- What would be the costs of the proposed elimination of the options market maker exception? How would the proposed elimination of the options market maker exception affect the liquidity of securities with options traded on them? Would the proposed elimination of the options market maker exception mean that fewer market makers would be willing to make markets in securities with options traded on them, and could the proposed amendment increase transaction costs for securities with options traded on them? Would such an effect, if any, be more severe for liquid or illiquid securities? Would it lead to fewer listed options?
- How much would this proposed amendment to the options market maker exception affect the compliance costs for small, medium, and large participants of a registered clearing agency and for options market makers (*e.g.*, personnel or system changes)? We seek comment on the costs of compliance that could arise as a result of the proposed amendment. For instance, to comply with the proposed amendment, would these entities be required to:
- Purchase new systems or implement changes to existing systems? Would changes to existing systems be significant? What would be the costs associated with acquiring new systems or making changes to existing systems? How much time would be required to fully implement any new or changed systems?
- Change existing records? What changes would need to be made? What would be the costs associated with any changes? How much time would be required to make any changes?
- Increase staffing and associated overhead costs? Would entities subject to the proposed amendment have to hire more staff? How many, and at what experience and salary level? Could existing staff be retrained? What would be the costs associated with hiring new staff or retraining existing staff? If retraining were required, what other costs could be incurred, *e.g.*, would retrained staff be unable to perform existing duties in order to comply with the proposed amendment? Would other resources need to be re-dedicated to comply with the proposed amendment?
- Implement, enhance or modify surveillance systems and procedures? Please describe what would be needed, and what costs would be incurred.
- Establish and implement new supervisory or compliance procedures, or modify existing procedures? What would be the costs associated with such changes? Would new compliance or

[137] *See, e.g.,* letter from Feeney, *supra* note 10.

[138] *See* Securities Exchange Act Release No. 56212 (Aug. 7, 2007); *see also* 2006 Proposing Release, 71 FR at 41711–41712.

[139] *See* Securities Exchange Act Release No. 56212 (Aug. 7, 2007).

supervisory personnel be needed? What would be the costs of obtaining such staff?

• Are there any costs that market participants could incur as a result of the proposed 35 consecutive settlement day phase-in period? Would the costs of a phase-in period be too significant to justify having one? Would a phase-in period create examination or surveillance difficulties? If so, how? What would be the costs and economic tradeoffs associated with longer or shorter phase-in periods?

• What would be the costs associated with including the pre-borrow requirement for the proposed amendment to the options market maker exception?

B. Alternatives to Eliminating the Options Market Maker Exception

1. Benefits

Due to the fact that large and persistent fails to deliver are not being closed out under existing delivery and settlement requirements and the fact that we are concerned that these fails to deliver may have a negative impact on the market for those securities, we believe that the options market maker exception to the mandatory close-out requirement of Rule 203(b)(3) of Regulation SHO should be eliminated.

In part, in anticipation of commenters stating that a limited options market maker exception is necessary we are requesting comment regarding two specific limited alternatives to elimination of the options market maker exception. Each of the proposed alternatives would provide for a 35 consecutive settlement day phase-in period similar to the phase-in period discussed above in connection with the proposed elimination of the options market maker exception for securities that are threshold securities on the effective date of the amendment and that have previously-excepted fail to deliver positions. The phase-in period would reduce any potential market disruption, such as increased volatility or short squeezes, from having to close-out previously-excepted fail to deliver positions because it would provide time for participants of a registered clearing agency to close out previously-excepted fail to deliver positions in an orderly manner, particularly because participants could begin closing out these fail to deliver positions at any time before the proposed 35 day phase-in period.

In addition, in response to comments about the proposed amendments to the options market maker exception in the 2006 Proposing Release that those proposed amendments would be costly and difficult to implement because portfolio hedging is the industry practice, the proposed alternatives would apply to fails to deliver resulting from short sales effected by a registered options market maker to establish or maintain a hedge on any options series, rather than an options position, created before an underlying security became a threshold security. Thus, the proposed alternatives would be more in line with industry practice and, therefore, less costly and difficult to implement than the commenters believed the proposed amendment in the 2006 Proposing Release would be.

The first alternative would require that a participant of a registered clearing agency that has a fail to deliver position in a threshold security that results or resulted from a short sale by a registered options market maker to establish or maintain a hedge on any options series within a portfolio that were created before the security became a threshold security 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. After the 35 consecutive settlement days has expired, any additional fails to deliver would be subject to the 13 consecutive settlement day close-out requirement of Rule 203(b)(3) of Regulation SHO. In addition, the proposed first alternative would impose a pre-borrow requirement similar to the pre-borrow requirement of Rule 203(b)(3)(iv) of Regulation SHO.

The second alternative would require that a participant of a registered clearing agency that has a fail to deliver position in a threshold security that results or resulted from a short sale by a registered options market maker to establish or maintain a hedge on any options series in 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 the earlier of: (i) 35 Consecutive settlement days from the date on which the security became a threshold security, or (ii) 13 consecutive settlement days from the last date on which all options series within the portfolio that were created before the security became a threshold security expire or are liquidated. After the 35 or 13 consecutive settlement days has expired, any additional fails to deliver would be subject to the 13 consecutive settlement day close-out requirement of Rule 203(b)(3) of Regulation SHO. In addition, the proposed amendment would impose a pre-borrow requirement similar to the pre-borrow requirement of Rule 203(b)(3)(iv) of Regulation SHO.

Similar to elimination of the options market maker exception, by proposing to require that all fails to deliver be closed out within specific time-frames, the proposed alternatives would reduce large and persistent fails to deliver. In addition, by proposing to require that shares be delivered to a buyer within a reasonable period of time, the proposed alternatives would result in shareholders receiving the benefits of ownership. Sellers would also be less able to unilaterally convert securities contracts into undated futures-type contracts to which the buyer would not have agreed, or that would have been priced differently. In addition, the delivery requirements of the proposed alternatives would enhance investor confidence as they make investment decisions by providing investors with greater assurance that securities would be delivered as expected.[140] An increase in investor confidence in the market could facilitate investment. The proposed alternatives could benefit issuers because investors may be more willing to commit capital where fails levels are lower.[141] In addition, some issuers could believe that a reduction in fails to deliver could reverse unwarranted reputational damage potentially caused by large and persistent fails to deliver and what they believe might be an indication of manipulative trading activities, such as ''naked'' short selling.[142] Thus, the proposed requirement that all fails to deliver be closed out within specific time-frames, as would be required by the proposed alternatives, could decrease the possibility of artificial market influences and, therefore, could contribute to price efficiency.

The proposed alternatives would also require that participants of a registered clearing agency and options market makers document that any fails to deliver in threshold securities that have not been closed out in accordance with the 13 consecutive settlement days close-out requirement of Rule 203(b)(3) of Regulation SHO qualify for the options market maker exception. The proposed alternatives would require both options market makers and participants of a registered clearing agency that rely on the options market maker exception to not close out a fail

[140] *See, e.g., supra* note 9 (citing to comment letters discussing the impact of fails to deliver on investor confidence).

[141] *See, e.g., supra* note 10 (citing to comment letters expressing concern regarding the impact of potential ''naked'' short selling on capital formation).

[142] *See, e.g., supra* note 11.

to deliver position in accordance with the mandatory close-out requirement of Rule 203(b)(3) of Regulation SHO to obtain, prepare, and keep documentation demonstrating that a fail to deliver position has not been closed out because it qualified for the exception. We anticipate such documentation could include, among other things, when the series being hedged was created, when the underlying security became a threshold security, and the age of the fail to deliver position that is not being closed out.

A documentation requirement would enable the Commission and the SROs to monitor more easily whether or not the options market maker exception is being applied correctly. In addition, the information would provide a record that would aid surveillance for compliance with this limited exception to Regulation SHO's close-out requirement.

We solicit comment on any additional benefits that could be realized with the proposed alternatives, including both short-term and long-term benefits. We solicit comment regarding other benefits to market efficiency, pricing efficiency, market stability, market integrity, and investor protection.

2. Costs

To comply with Regulation SHO when it became effective in January 2005, market participants needed to modify their recordkeeping, systems, and surveillance mechanisms. In addition, market participants should have retained and trained the necessary personnel to ensure compliance with the rule. Thus, for the most part the infrastructure necessary to comply with the proposed alternatives should already be in place because the proposed alternatives, if adopted, would require that all fails to deliver be closed out in accordance with specific time-frames similar to the mandatory 13 consecutive settlement day close-out requirement of Regulation SHO. In addition, similar to the current options market maker exception in Regulation SHO, the proposed alternatives would only except from the mandatory close-out requirement of Rule 203(b)(3) those fails to deliver that resulted from short sales by a registered options market maker in connection with options created before the security became a threshold security.

The proposed alternatives, however, would result in some increased recordkeeping, systems, and surveillance costs. The proposed alternatives would require that participants of a registered clearing agency, and options market makers for which they clear transactions, have the necessary recordkeeping, systems, and surveillance mechanisms in place to track whether a fail to deliver position resulted from a short sale effected by a registered options market maker to maintain or establish a hedge on option series created before the security became a threshold security. In addition, under the first proposed alternative, these entities would need to have systems and surveillance mechanisms in place to ensure that such fails to deliver are closed out within 35 consecutive settlement days of the security becoming a threshold security. Under the second proposed alternative, these entities would need to have systems and surveillance mechanisms in place to determine whether the fails to deliver would be required to be closed out within the earlier of 13 consecutive settlement days of all options series within the portfolio expiring or being liquidated, or within 35 consecutive settlement days of the security becoming a threshold security. Thus, participants of a registered clearing agency, and options market makers for which they clear, could incur costs in meeting these requirements.

In addition, the proposed alternatives would allow for a one-time 35 consecutive settlement day phase-in period for previously-excepted fail to deliver positions. Although any personnel, computer hardware and software, recordkeeping, or surveillance costs, associated with complying with this proposed phase-in period would not be an ongoing cost, entities subject to the requirement could incur some one-time costs in complying with this proposed requirement.

Any costs associated with compliance with the proposed pre-borrow requirement for fail to deliver positions that are not closed out within the applicable time-frames set forth in the proposed alternatives should be limited, if any. The proposed pre-borrow requirements in the proposed alternatives are similar to the pre-borrow requirement of Rule 203(b)(3)(iii) of Regulation SHO, as originally adopted. Thus, participants of a registered clearing agency, and any broker-dealers for which it clears transactions, must already comply with such a requirement if a fail to deliver position has not been closed out in accordance with Regulation SHO's mandatory close-out requirement. Accordingly, these entities should already have in place the personnel, recordkeeping, systems, and surveillance mechanisms necessary to comply with the proposed pre-borrow requirement.

As discussed above in connection with costs regarding the proposed elimination of the options market maker exception, although we recognize commenters' concerns that a mandatory close-out requirement for fails to deliver in threshold securities underlying options positions could potentially impact options market makers' willingness to provide liquidity in threshold securities, make it more costly for options market makers to accommodate customer orders, or result in wider bid-ask spreads or less depth,[143] we believe the mandatory close-out requirements of each of the proposed alternatives would similarly minimally impact, if at all, liquidity, hedging costs, spreads, or depth in the securities subject to the close-out requirements of the proposed alternatives, or the willingness of options market makers to make markets in such securities.

We believe that these potential effects of the close-out requirements of the proposed alternatives would be minimal, if any, because the number of securities that would be impacted by the close-out requirements of the proposed alternatives would be small. The proposed alternatives would apply only to those threshold securities with listed options[144] and would only impact fails to deliver in those securities that resulted from short sales by registered options market makers to hedge options series that were created before rather than after the security became a threshold security because all other fails to deliver in threshold securities are subject to Regulation SHO's current mandatory 13 consecutive settlement day close-out requirement.

In addition, the proposed alternatives would provide options market makers with flexibility in conducting their hedging activities because they would each allow an extended period of time (*i.e.*, 35 consecutive settlement days for purposes of Alternative 1 and 13 or 35 consecutive settlement days for purposes of Alternative 2) within which to close out all fails to deliver in threshold securities. As discussed above in connection with the proposed amendment to eliminate the options market maker exception, we believe that even a 13 consecutive settlement day close-out requirement would result in minimal impact on the willingness of

[143] *See, e.g.*, letters from CBOE, *supra* note 31; Citigroup, *supra* note 31.

[144] *See* letter from Options Exchanges, *supra* note 49 (discussing the number of threshold securities with listed options).

options market makers to make markets, liquidity, hedging costs, depth, and spreads because it would allow options market makers flexibility in conducting their hedging activities by permitting fails to deliver to remain open for an extended period of time (*i.e.*, 13 consecutive settlement days) rather than, for example, requiring that such fails to deliver be closed out immediately, or even within the standard 3-day settlement period. During the period of time that the fail to deliver position can remain open, options market makers would be able to continue any hedging activity without having to close out the fail to deliver position or pre-borrow to maintain the hedge.

In addition, we believe the proposed 35 consecutive settlement day phase-in period should not result in market disruption, such as increased volatility or short squeezes, because it would provide time for participants of a registered clearing agency to close out previously-excepted fail to deliver positions in an orderly manner, particularly because participants could begin closing out previously-excepted fail to deliver positions at any time before the proposed 35 day phase-in period.

As discussed above in connection with the costs associated with elimination of the options market maker exception, to the extent that the mandatory close-out requirements of the proposed alternatives could potentially impact liquidity, hedging costs, depth, or spreads, or impact the willingness of options market makers to make markets in securities subject to the proposed alternatives, we believe such effects are justified by our belief that fails to deliver resulting from hedging activities by options market makers should be treated similarly to fails to deliver resulting from sales in the equities markets so that market participants trading threshold securities in the options markets do not receive an advantage over those trading such securities in the equities markets. In addition, we believe that such potential costs would be justified by the benefits, as discussed above, of requiring that all fails to deliver be closed out within specific time-frames rather than being allowed to continue indefinitely.

Although the proposed alternatives would lessen the potential negative impact on the market of large and persistent fails to deliver similar to the proposed elimination of the options market maker exception because they would require that fails to deliver in threshold securities eventually be closed out, we believe that the proposed elimination of the options market maker exception would achieve this goal more effectively because under the proposed elimination of the options market maker exception, all fails to deliver in threshold securities would have to be closed out within Regulation SHO's mandatory 13 consecutive settlement day close-out requirement. The proposed alternatives, however, would each allow a longer period of time for fail to deliver positions to be closed out. Specifically, the first alternative would allow certain fails to deliver to be closed out within 35 consecutive settlement days of the security becoming a threshold security. Under the second alternative, although some fails to deliver would be required to be closed out in less than 35 consecutive settlement days, other fails to deliver would not have be closed out until 35 consecutive settlement days from the security becoming a threshold security.

The proposed alternatives would also impose recordkeeping costs not imposed by the proposed amendment to eliminate the options market maker exception. The documentation requirement of the proposed alternatives would require options market makers and participants of a registered clearing agency to obtain, prepare, and keep documentation demonstrating that a fail to deliver position has not been closed out because it was eligible for the exception. This documentation requirement could result in these entities incurring costs related to personnel, recordkeeping, systems and surveillance mechanisms. For example, as discussed in detail in Section VI.D.i. above, for purposes of the PRA, we estimate that it would take each options market maker or participant of a registered clearing agency no more than approximately 10 minutes to document that a fail to deliver position has not been closed out due to its eligibility for the options market maker exception. In addition, we estimate that the total annual hour burden per year for each options market maker subject to the documentation requirement would be 3,024 burden hours. We estimate that the total annual hour burden per year for each participant of a registered clearing agency subject to the documentation requirement would be 120 burden hours.

We request specific comment on the systems changes to computer hardware and software, or surveillance costs that would be necessary to implement the proposed alternatives. Specifically:

- What would be the costs and benefits of the proposed alternatives to elimination of the options market maker exception? For instance, what would be the costs of the proposed alternatives if either of the alternatives were to reduce the willingness of options market makers to make markets in securities that could become threshold securities or in threshold securities?
- What would be the costs associated with including the pre-borrow requirement for the proposed alternatives to the options market maker exception? What would be the costs of excluding a pre-borrow requirement for these proposals?
- What costs would be associated with the documentation requirement of the proposed alternatives?
- Based on the current requirements of Regulation SHO, what have been the costs and benefits of the current options market maker exception?
- What would be the specific costs associated with any technical or operational challenges that options market makers would face in complying with the proposed alternatives?
- Would the proposed alternatives create any costs, such as costs associated with systems, surveillance, or recordkeeping modifications that may be needed for participants to track fails to deliver subject to the proposed alternatives? If there were any costs associated with tracking fails to deliver would these costs justify the benefits of providing firms with additional time to close out fails to deliver resulting from short sales effected to establish or maintain a hedge on options series that were created before the security becomes a threshold security?
- How much would the proposed alternatives affect compliance costs for small, medium, and large participants of a clearing agency or options market maker for which they clear transactions (*e.g.*, personnel or system changes)? We seek comment on the costs of compliance that may arise. For instance, to comply with the proposed alternatives, would these entities be required to:
- Purchase new systems or implement changes to existing systems? Would changes to existing systems be significant? What would be the costs associated with acquiring new systems or making changes to existing systems? How much time would be required to fully implement any new or changed systems?
- Change existing records? What changes would need to be made? What would be the costs associated with any changes? How much time would be required to make any changes?
- Increase staffing and associated overhead costs? Would entities subject to the proposed alternatives have to hire more staff? How many, and at what

experience and salary level? Could existing staff be retrained? What would be the costs associated with hiring new staff or retraining existing staff? If retraining were required, what other costs could be incurred, *e.g.*, would retrained staff be unable to perform existing duties in order to comply with the proposed amendment? Would other resources need to be re-dedicated to comply with the proposed amendment?

- Implement, enhance or modify surveillance systems and procedures? Please describe what would be needed, and what costs would be incurred.
- Establish and implement new supervisory or compliance procedures, or modify existing procedures? What would be the costs associated with such changes? Would new compliance or supervisory personnel be needed? What would be the costs of obtaining such staff?
- Are there any costs that participants could incur as a result of the proposed 35 consecutive settlement day phase-in period? Would the costs of a phase-in period be too significant to justify having one? Would a phase-in period create examination or surveillance difficulties? If so, how? What would be the costs and economic tradeoffs associated with longer or shorter phase-in periods?

C. Proposed Amendment to Rule 200(g)(1) of Regulation SHO

1. Benefits

We are proposing for comment a documentation requirement for broker-dealers marking orders to sell ''long'' pursuant to Regulation SHO that would require such broker-dealers to document the present location of the securities being sold. We believe that such a proposed documentation requirement would aid in ensuring the correct marking of sell orders. To the extent that the seller is unable to provide the present location of the securities being sold, the broker-dealer would have reason to believe that the seller is not ''deemed to own'' the securities being sold and that the securities would not be in its physical possession or control no later than settlement of the transaction and, therefore, that the broker-dealer would be required to mark the sale ''short'' rather than ''long.'' [145] We believe that this proposed documentation requirement could also reduce the number of fails to deliver because, after making the inquiry into the present location of the securities being sold, a broker-dealer would know whether or not it needed to obtain securities for delivery.

We are concerned that broker-dealers marking orders ''long'' may not be making a determination prior to marking the order that the seller is ''deemed to own'' the security being sold. Rule 200(g)(1) currently requires that broker-dealers ascertain whether the customer is ''deemed to own'' the securities being sold before marking a sell order ''long.'' [146] Thus, we believe that the proposed documentation requirement would help ensure that the broker-dealer marking the sale ''long'' has inquired into, and determined that, the seller is ''deemed to own'' the securities being sold because the broker-dealer would be required to document the present location of the securities being sold.

We also believe that the proposed documentation requirement would enable the Commission and SROs to more easily examine for compliance with the long sale marking provisions of Rule 200(g) more effectively because this proposed documentation requirement would provide a record that the seller is ''deemed to own'' the securities being sold in compliance with that rule. We also believe that the proposed documentation requirement would aid the Commission and SROs in reviewing for mismarking designed to avoid compliance with other rules and regulations of the federal securities laws, such as the ''locate'' requirement of Regulation SHO,[147] and Rule 105 of Regulation M.[148]

2. Costs

In response to our request for comment in the 2006 Proposing Release regarding a long sale documentation requirement, commenters stated that pre-trade documentation would unnecessarily impair efficiency as broker-dealers already have procedures to ensure orders are marked properly based on information provided by customers and their own books and records, and that documentation requirements would add substantial cost.[149] One commenter also stated that compliance with such pre-trade documentation requirements would require a complete revamping of front end systems.[150] Another commenter stated that the requirements would be inconsistent with the goal of fostering liquidity.[151]

Although commenters stated that pre-trade documentation for long sales would be inconsistent with the goal of fostering liquidity, would unnecessarily impair efficiency, and would add substantial cost, we believe that such costs, to the extent that there are any, would be justified by the benefits of a documentation requirement, as discussed above.

In addition, we note that under former NASD Rule 3370(b), NASD member firms making an affirmative determination that a customer was long were required to make a notation on the order ticket at the time an order was taken which reflected the conversation with the customer as to the present location of the securities, whether they were in good deliverable form, and the customer's ability to deliver them to the member within three business days.[152] Thus, many broker-dealers should already be familiar with a documentation requirement and one method that could be used to comply with such a requirement. Such familiarity should help reduce any costs associated with implementing the proposed documentation requirement. In addition, unlike with former NASD Rule 3370(b), the proposed amendment would not specify the format or methodology of the proposed documentation requirement. The absence of such specifications should help reduce costs to broker-dealers that would have to comply with this proposal because broker-dealers would be able to determine the most cost effective format and methodology for meeting the proposed documentation requirement.

We believe that any costs that would arise from the proposed requirement that a broker-dealer must document the present location of securities being sold long when making the determination that a customer is deemed to own the securities being sold would be minimal because Rule 200(g)(1) currently requires that broker-dealers must ascertain whether the customer is ''deemed to own'' the securities being sold before marking a sell order ''long.'' [153] Today's proposed amendment would require that the broker-dealer take the additional step of documenting the present location of the securities being sold. Broker-dealers could, however, need to put mechanisms in place to facilitate efficient documenting of the

[145] *See* 17 CFR 242.200(g).

[146] *See id.*

[147] *See supra,* note 92.

[148] *See supra,* note 93.

[149] *See* letters from MFA, *supra* note 75; UBS, *supra* note 31; Knight, *supra* note 75.

[150] *See* letter from SIA, *supra* note 31.

[151] *See* letter from Millennium, *supra* note 75.

[152] Brokers and dealers that were members of the NASD were obligated to comply with former NASD Rule 3370(b) prior to the adoption of Regulation SHO.

[153] *See* 17 CFR 242.200(g)(1).

information required by the proposed amendment.

As discussed above in Section VI.D.ii., the paperwork burden is estimated at approximately 49 burden hours for each broker-dealer registered with the Commission, if the documentation process were automated. To the extent that broker-dealers need to automate the documentation process, we anticipate that such broker-dealers would spend varying amounts of time reprogramming systems, integrating systems, and potentially updating front-end software. Some broker-dealers may spend very little time automating the documentation process, while changes at other broker-dealers might be more involved. On average, we estimate that reprogramming burdens at a broker-dealer would be approximately 16 hours (or two days) with one programmer. This would cost $1,072 per broker-dealer (16 hours @ $67 per hour) or an aggregate of $6,226,176 across all broker-dealers.[154]

The Commission does not believe there are any additional costs to this proposal; however we seek any data supporting any additional costs not mentioned. In addition, we request specific comment on any systems changes to computer hardware and software, or surveillance costs that might be necessary to implement the proposed amendment. Specifically:

- What would be the costs and benefits of the proposed documentation requirement?
- Would the proposed amendment create any costs, such as costs associated with systems, surveillance, or recordkeeping modifications that may be needed for broker-dealers to document the present location of shares being sold? If there were any costs associated with the proposed documentation requirement would these costs justify the benefits of better ensuring compliance with federal securities laws?
- How much would the proposed amendment affect compliance costs for small, medium, and large broker-dealers (*e.g.*, personnel or system changes)? We seek comment on the costs of compliance that may arise. For instance, to document the location of shares being sold, would these entities be required to:
- Purchase new systems or implement changes to existing systems? Would changes to existing systems be significant? What would be the costs associated with acquiring new systems or making changes to existing systems? How much time would be required to fully implement any new or changed systems?
- Change existing records? What changes would need to be made? What would be the costs associated with any changes? How much time would be required to make any changes?
- Increase staffing and associated overhead costs? Would entities subject to the proposed amendment have to hire more staff? How many, and at what experience and salary level? Could existing staff be retrained? What would be the costs associated with hiring new staff or retraining existing staff? If retraining were required, what other costs could be incurred, *e.g.*, would retrained staff be unable to perform existing duties in order to comply with the proposed amendment? Would other resources need to be re-dedicated to comply with the proposed amendment?
- Implement, enhance or modify surveillance systems and procedures? Please describe what would be needed, and what costs would be incurred.
- Establish and implement new supervisory or compliance procedures, or modify existing procedures? What would be the costs associated with such changes? Would new compliance or supervisory personnel be needed? What would be the costs of obtaining such staff?

VIII. Consideration of Burden and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation.[155] In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when making rules under the Exchange Act, to consider the impact such rules would have on competition.[156] Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

We believe the proposed amendments, including the proposed alternatives, would have minimal impact on the promotion of price efficiency. In the 2006 Proposing Release we sought comment on whether the proposals would promote price efficiency, including whether the proposals might impact liquidity and the potential for manipulative short squeezes. One commenter stated that the Commission's concern over potential short squeezes is ''misplaced,'' as this is a risk short sellers assume when they sell short.[157] Other commenters stated, however, that the proposed amendment to the options market maker exception would disrupt the markets because they would not provide sufficient flexibility to permit efficient hedging by options market makers, would unnecessarily increase risks and costs to hedge, and would adversely impact liquidity and result in higher costs to customers.[158] These commenters stated that they believe the proposed amendments would likely discourage options market makers from making markets in illiquid securities since the risk associated in maintaining the hedges in these option positions would be too great.[159] Moreover, these commenters stated that the reluctance of options market makers to make markets in threshold securities would result in wider spreads in such securities to account for the increased costs of hedging, to the detriment of investors.[160]

Although we recognize commenters' concerns that a mandatory close-out requirement for fails to deliver in threshold securities underlying options positions could potentially impact options market makers' willingness to provide liquidity in threshold securities, make it more costly for options market makers to accommodate customer orders, or result in wider bid-ask spreads or less depth,[161] we believe that the proposed elimination of the options market maker exceptions, and the mandatory close-out requirements of the proposed alternatives, would minimally impact, if at all, liquidity, hedging costs, spreads, or depth in the securities subject to these proposals, or the willingness of options market makers to make markets in such securities.

We believe that these potential effects of the elimination of the options market maker exception, or the proposed close-out requirements of the proposed alternatives would be minimal, if any, because the number of securities that would be impacted by these proposals

[154] The $67/hour figure for a computer programmer is based on the salary for a Senior Computer Operator from the SIA *Report on Office Salaries in the Securities Industry 2006,* modified to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead.

[155] 15 U.S.C. 78c(f).

[156] 15 U.S.C. 78w(a)(2).

[157] *See* letter from H. Glenn Bagwell, Jr., dated Sept. 19, 2006.

[158] *See, e.g.*, letter from CBOE, *supra* note 31.

[159] *See id.*

[160] *See* letter from Citigroup, *supra* note 31.

[161] *See, e.g.*, letters from CBOE, *supra* note 31; Citigroup, *supra* note 31.

would be relatively small. The proposal would apply only to those threshold securities with listed options[162] and would only impact fails to deliver in those securities that resulted from short sales by registered options market makers to hedge options series (or options positions in the case of the proposed elimination of the current options market maker exception) that were created before, rather than after, the security became a threshold security because all other fails to deliver in threshold securities are currently subject to Regulation SHO's mandatory 13 consecutive settlement day close-out requirement.

In addition, as discussed above in connection with the proposed amendment to eliminate the options market maker exception, we believe that even a 13 consecutive settlement day close-out requirement would result in minimal impact on the willingness of options market makers to make markets, liquidity, hedging costs, depth, and spreads of a mandatory close-out requirement because it would allow options market makers flexibility in conducting their hedging activities by permitting fails to deliver to remain open for an extended period of time (*i.e.*, 13 consecutive settlement days) rather than, for example, requiring that such fails to deliver be closed out immediately, or even within the standard 3-day settlement period. The close-out requirements of the proposed alternatives would provide options market makers with even greater flexibility in conducting their hedging activities because they would each allow even longer periods of time than the 13 consecutive settlement days allowed by current Rule 203(b)(3) of Regulation SHO (*i.e.*, 35 consecutive settlement days for purposes of proposed Alternative 1, and 13 or 35 consecutive settlement days for purposes of proposed Alternative 2) within which to close out all fails to deliver in threshold securities.

In addition, we believe the proposed 35 consecutive settlement day phase-in period for each of the proposals should not result in market disruption, such as increased volatility or short squeezes, because it would provide time for participants of a registered clearing agency to close out previously-excepted fail to deliver positions in an orderly manner, particularly because participants could begin closing out previously-excepted fail to deliver positions at any time before the proposed 35 day phase-in period.

To the extent that a mandatory close-out requirement could potentially impact liquidity, hedging costs, depth, or spreads, or impact the willingness of options market makers to make markets in securities subject to such a requirement, we believe such effects are justified by our belief that fails to deliver resulting from hedging activities by options market makers should be treated similarly to fails to deliver resulting from sales in the equities markets so that market participants trading threshold securities in the options markets do not receive an advantage over those trading such securities in the equities markets. In addition, we believe that such potential costs would be justified by the benefits, as discussed below, of requiring that all fails to deliver be closed out within specific time-frames rather than being allowed to continue indefinitely.

The proposed amendment to Rule 200(g) of Regulation SHO to require broker-dealers to document the present location of securities being sold in connection with an order marked ''long'' would promote price efficiency by reducing non-compliance with short sale-related regulations, such as Rule 105 of Regulation M, that we believe are beneficial to pricing efficiency.

In addition, we believe that the proposed amendments, including the alternative proposals, would have minimal impact on the promotion of capital formation. Large and persistent fails to deliver can deprive shareholders of the benefits of ownership, such as voting and lending. They can also be indicative of potentially manipulative conduct, such as abusive ''naked'' short selling. The deprivation of the benefits of ownership, as well as the perception that abusive ''naked'' short selling is occurring in certain securities, can undermine the confidence of investors. These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to such manipulative conduct. In the 2006 Proposing Release, we sought comment on whether the proposed amendments would promote capital formation, including whether the proposed increased short sale restrictions would affect investors' decisions to invest in certain equity securities. Commenters expressed concern about the potential impact of ''naked'' short selling on capital formation claiming that ''naked'' short selling causes a drop in an issuer's stock price that may limit the issuer's ability to access the capital markets.[163] Another commenter submitted a theoretical economic study concluding that ''naked'' short selling is economically similar to other short selling.[164]

By requiring that all fails to deliver in threshold securities be closed out within specific time-frames rather than allowing them to continue indefinitely, we believe that there would be a decrease in the number of threshold securities with persistent and high levels of fails to deliver. If persistence on the threshold securities lists leads to an unwarranted decline in investor confidence about the security, the proposed amendments should improve investor confidence about the security. We also believe that the proposed amendments should lead to greater certainty in the settlement of securities which should strengthen investor confidence in the settlement process. The reduction in fails to deliver and the resulting reduction in the number of securities on the threshold securities lists could result in increased investor confidence.

The proposed amendment to eliminate the options market maker exception and the proposed alternatives also would not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. By eliminating the options market maker exception, or, alternatively, adopting a limited options market maker exception, the Commission believes the proposals would promote competition by requiring similarly situated participants of a registered clearing agency, or options market makers for which they clear transactions, to close out fails to deliver in threshold securities within similar time-frames.

The Commission requests comment on whether the proposed amendment to eliminate the options market maker exception, the proposed alternatives, and the proposed amendment to Rule 200(g) of Regulation SHO, would promote efficiency, competition, and capital formation.

IX. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or ''SBREFA,'' [165] we must advise the Office of Management and Budget as to whether the proposed regulation constitutes a ''major'' rule. Under

[162] *See* letter from Options Exchanges, *supra* note 49 (discussing the number of threshold securities with listed options).

[163] *See, e.g.*, letter from Feeney, *supra* note 10.

[164] *See* comment letter from J.B. Heaton, Bartlit Beck Herman Palenchar & Scott LLP, dated May 1, 2007.

[165] Pub. L. No. 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

SBREFA, a rule is considered ''major'' where, if adopted, it results or is likely to result in:

- An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effect on competition, investment or innovation.

If a rule is ''major,'' its effectiveness will generally be delayed for 60 days pending Congressional review. We request comment on the potential impact of the proposed amendments on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

X. Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (''IRFA''), in accordance with the provisions of the Regulatory Flexibility Act (''RFA''),[166] regarding the proposed amendments to Rules 200 and 203 of Regulation SHO under the Exchange Act.

A. Reasons for the Proposed Action

On July 14, 2006, the Commission published proposed amendments to the options market maker exception contained in Regulation SHO to limit the duration of the exception.[167] We proposed to narrow the options market maker exception at that time because we have observed a small number of threshold securities with substantial and persistent fail to deliver positions that are not being closed out under existing delivery and settlement requirements, and we believe that these persistent fail to deliver positions are attributable, in part, to the current options market maker exception in Regulation SHO.[168]

As a result of the comment process, however, we learned that the amendment, as proposed, could be very costly and difficult to implement or possibly unworkable because options market makers typically use hedges to manage the risk of an entire inventory, not just a specific options position. In addition, some commenters' statements indicated to us that options market makers may be interpreting the current options market maker exception more broadly than the Commission intended and possibly in violation of the exception. We also remain concerned that large and persistent fails to deliver may have a negative effect on the market in these securities. Although high fails levels exist only for a small percentage of securities, these fails to deliver could potentially impede the orderly functioning of the market for such securities, particularly less liquid securities. For example, a significant level of fails to deliver in a security may have adverse consequences for shareholders who may be relying on delivery of those shares for voting and lending purposes, or may otherwise affect an investor's decision to invest in that particular security. In addition, a seller that fails to deliver securities on settlement date effectively unilaterally converts a securities contract into an undated futures-type contract, to which the buyer might not have agreed, or that might have been priced differently.

Thus, we determined to re-propose amendments to the options market maker exception that would eliminate the exception. In addition, we are requesting comment regarding two specific alternatives to our proposal to eliminate the options market maker exception that would require fails to deliver in threshold securities underlying options to be closed out within specific time-frames. By re-proposing amendments to the options market maker exception we seek additional information regarding the options markets that might assist us in determining whether or not to eliminate the options market maker exception.

We are also proposing an amendment to the long sale marking provisions of Rule 200(g)(1) of Regulation SHO that would require that broker-dealers marking orders to sell ''long'' document the present location of the securities. We believe that such a proposed documentation requirement would aid in ensuring the correct marking of sell orders. To the extent that the seller is unable to provide the present location of the securities being sold, the broker-dealer would have reason to believe that the seller is not ''deemed to own'' the securities being sold and that the securities would not be in its physical possession or control no later than settlement of the transaction and, therefore, that the broker-dealer would be required to mark the sale ''short'' rather than ''long.'' [169] We believe that this proposed documentation requirement could also reduce the number of fails to deliver because, after making the inquiry into the present location of the securities being sold, a broker-dealer would know whether or not it needed to obtain securities for delivery.

We are concerned that broker-dealers marking orders ''long'' may not be making a determination prior to marking the order that the seller is ''deemed to own'' the security being sold. Rule 200(g)(1) currently requires that broker-dealers ascertain whether the customer is ''deemed to own'' the securities being sold before marking a sell order ''long.'' [170] Thus, we believe that the proposed documentation requirement would help ensure that the broker-dealer marking the sale ''long'' has inquired into, and determined that, the seller is ''deemed to own'' the securities being sold because the broker-dealer would be required to document the present location of the securities being sold.

We also believe that the proposed documentation requirement would enable the Commission and SROs to more easily examine for compliance with the long sale marking provisions of Rule 200(g) more effectively because this proposed documentation requirement would provide a record that the seller is ''deemed to own'' the securities being sold in compliance with that rule. We also believe that the proposed documentation requirement would aid the Commission and SROs in reviewing for mismarking designed to avoid compliance with other rules and regulations of the federal securities laws, such as the ''locate'' requirement of Regulation SHO,[171] and Rule 105 of Regulation M.[172]

B. Objectives

Our proposals regarding the options market maker exception are intended to further reduce the number of persistent fails to deliver in threshold securities. The proposed amendment to eliminate the options market maker exception, and the alternative proposals, are designed to help reduce persistent and large fail to deliver positions which may have a negative effect on the market in these securities and also could be used to facilitate manipulative trading strategies.

Although high fails levels exist only for a small percentage of issuers,[173] they could impede the orderly functioning of the market for such issuers, particularly issuers of less liquid securities. For example, a significant level of fails to deliver in a security may have adverse consequences for shareholders who may be relying on delivery of those shares for

[166] 5 U.S.C. 603.

[167] 2006 Proposing Release, 71 FR 41710.

[168] *See id.* at 41712; Regulation SHO Re-Opening Release, 72 FR at 15079–15080.

[169] *See* 17 CFR 242.200(g).

[170] *See id.*

[171] *See supra*, note 92.

[172] *See supra*, note 93.

[173] *See supra* note 7.

voting and lending purposes, or may otherwise affect an investor's decision to invest in that particular security. In addition, a seller that fails to deliver securities on settlement date effectively unilaterally converts a securities contract into an undated futures-type contract, to which the buyer might not have agreed, or that would have been priced differently.

To allow market participants sufficient time to comply with the new close-out requirements, the proposed amendment to eliminate the options market maker exception and the proposed alternatives would include a one-time 35 consecutive settlement day phase-in period following the effective date of the amendment. The phase-in period would provide participants flexibility in closing out previously-excepted fail to deliver positions.

By proposing an amendment to Rule 200(g)(1) of Regulation SHO that would require broker-dealers to document the present location of securities a customer is deemed to own, we intend to aid surveillance for compliance with the marking requirements of Rule 200(g). In addition, such a requirement would help to ensure that broker-dealers only mark orders ''long'' after making a determination that a customer actually owns the securities being sold.

C. Legal Basis

Pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 9(h), 10(a), 11A, 15, 17(a), 19, 23(a) thereof, 15 U.S.C. 78b, 78c, 78i, 78j, 78k–l, 78o, 78q, 78s, 78w(a), the Commission is proposing amendments to §§ 242.200 and 242.203 of Regulation SHO.

D. Small Entities Subject to the Rule

The entities covered by these proposals would include small entities that are participants of a registered clearing agency, including small registered options market makers for which the participant clears trades or for which it is responsible for settlement. In addition, the entities covered by these proposals would include small entities that are market participants that effect sales subject to the requirements of Regulation SHO. Most small entities subject to the proposed amendments, including the proposed alternatives, would be registered broker-dealers. Although it is impossible to quantify every type of small entity covered by these proposals, Paragraph (c)(1) of Rule 0–10 [174] states that the term ''small business'' or ''small organization,'' when referring to a broker-dealer, means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to § 240.17a–5(d); and is not affiliated with any person (other than a natural person) that is not a small business or small organization. As of 2006, the Commission estimates that there were approximately 894 registered broker-dealers that qualified as small entities as defined above.[175]

As noted above, the entities covered by these amendments will include small entities that are participants of a registered clearing agency. As of May 2007, approximately 90% of participants of the NSCC, the primary registered clearing agency responsible for clearing U.S. transactions, were registered as broker-dealers. Participants not registered as broker-dealers include such entities as banks, U.S.-registered exchanges, and clearing agencies. Although these entities are participants of a registered clearing agency, generally these entities do not engage in the types of activities that would implicate the close-out requirements of Regulation SHO. Such activities of these entities include creating and redeeming Exchange Traded Funds, trading in municipal securities, and using NSCC's Envelope Settlement Service or Inter-city Envelope Settlement Service. These activities rarely lead to fails to deliver and, if fails to deliver do occur, they are small in number and are usually cleaned up within a day. Thus, such fails to deliver would not trigger the close-out provisions of Regulation SHO.

The federal securities laws do not define what is a ''small business'' or ''small organization'' when referring to a bank. The Small Business Administration regulations define ''small entities'' to include banks and savings associations with total assets of $165 million or less.[176] As of May, 2007 no bank that was a participant of the NSCC was a small entity because none met this criteria.

Paragraph (e) of Rule 0–10 under the Exchange Act [177] states that the term ''small business'' or ''small organization,'' when referring to an exchange, means any exchange that: (1) Has been exempted from the reporting requirements of Rule 11Aa3–1 under the Exchange Act; and (2) is not affiliated with any person (other than a natural person) that is not a small business or small organization, as defined by Rule 0–10. No U.S. registered exchange is a small entity because none meets these criteria. There is one national securities association (NASD) that is subject to these amendments. NASD is not a small entity as defined by 13 CFR 121.201.

Paragraph (d) of Rule 0–10 under the Exchange Act [178] states that the term ''small business'' or ''small organization,'' when referring to a clearing agency, means a clearing agency that: (1) Compared, cleared and settled less than $500 million in securities transactions during the preceding fiscal year (or in the time that it has been in business, if shorter); (2) had less than $200 million in funds and securities in its custody or control at all times during the preceding fiscal year (or in the time that it has been in business, if shorter); and (3) is not affiliated with any person (other than a natural person) that is not a small business or small organization as defined by Rule 0–10. No clearing agency that is subject to the requirements of Regulation SHO is a small entity because none meets these criteria.

E. Reporting, Recordkeeping, and Other Compliance Requirements

The proposed amendment to eliminate the options market maker exception, and the proposed alternatives, would impose some new or additional reporting, recordkeeping, or compliance costs on broker-dealers that are small entities. In order to comply with Regulation SHO when it became effective in January, 2005, entities needed to modify their systems and surveillance mechanisms. Thus, the infrastructure necessary to comply with the proposed amendments regarding elimination of the options market maker exception should already be in place. Any additional changes to the infrastructure should be minimal. In addition, entities that would be subject to the mandatory 13 consecutive settlement day close-out requirement of Rule 203(b)(3) of Regulation SHO should already have systems in place to close out non-excepted fails to deliver as required by Regulation SHO. These entities, however, could be required to modify their systems and surveillance mechanisms to ensure compliance with the proposed alternatives to eliminating the options market maker exception.

These entities could also be required to put in place mechanisms to facilitate communications between participants

[174] 17 CFR 240.0–10(c)(1).

[175] These numbers are based on the Commission's Office of Economic Analysis's review of 2006 FOCUS Report filings reflecting registered broker dealers. This number does not include broker-dealers that are delinquent on FOCUS Report filings.

[176] *See* 13 CFR 121.201.

[177] 17 CFR 240.0–10(e).

[178] 17 CFR 240.0–10(d).

of a registered clearing agency and options market makers to meet the documentation requirements of the proposed alternatives. We solicit comment on what new recordkeeping, reporting or compliance requirements could arise as a result of the proposed amendment to eliminate the options market maker exception and the proposed alternatives to elimination that would require fails to deliver in threshold securities underlying options to be closed out within specific time-frames.

The proposed amendment to Rule 200(g)(1) that would require that broker-dealers document the present location of securities a customer is deemed to own prior to marking an order to sell ''long'' could impose some new or additional reporting, recordkeeping, or compliance costs on broker-dealers that are small entities. We believe, however, that such costs should be minimal. Rule 200(g)(1) currently requires that broker-dealers must determine whether the customer is ''deemed to own'' the securities being sold before marking a sell order ''long.'' Today's proposed amendment would require that the broker-dealer take the additional step of documenting the present location of the securities being sold. Broker-dealers may, however, need to put mechanisms in place to facilitate efficient documenting of the information that would be required by the proposed amendment.

Moreover, we note that under former NASD Rule 3370(b), NASD member firms making an affirmative determination that a customer was long were required to make a notation on the order ticket at the time an order was taken which reflected the conversation with the customer as to the present location of the securities, whether they were in good deliverable form, and the customer's ability to deliver them to the member within three business days. Thus, many broker-dealers that are small entities should already be familiar with a documentation requirement and with one method that could be used to comply with such a requirement. We solicit comment, however, on what new recordkeeping, reporting or compliance requirements may arise as a result of the proposed amendment to Rule 200(g)(1) of Regulation SHO.

F. Duplicative, Overlapping or Conflicting Federal Rules

The Commission believes that there are no federal rules that duplicate, overlap, or conflict with the proposed amendments.

G. Significant Alternatives

The RFA directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small issuers and broker-dealers. Pursuant to Section 3(a) of the RFA,[179] the Commission must consider the following types of alternatives: (a) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the rule, or any part thereof, for small entities.

A primary goal of the proposed amendment to eliminate the options market maker exception, and the proposed alternatives, is to reduce the number of persistent fails to deliver in threshold securities. As such, we believe that imposing different compliance requirements, and possibly a different timetable for implementing compliance requirements, for small entities would undermine the goal of reducing fails to deliver. In addition, we have concluded similarly that it would not be consistent with the primary goal of the proposals to further clarify, consolidate or simplify the proposals for small entities. Finally, the proposals would impose performance standards rather than design standards.

H. Request for Comments

The Commission encourages the submission of written comments with respect to any aspect of the IRFA. In particular, the Commission seeks comment on: (i) The number of small entities that would be affected by the proposed amendments; and (ii) the existence or nature of the potential impact of the proposed amendments on small entities. Those comments should specify costs of compliance with the proposed amendments, and suggest alternatives that would accomplish the objective of the proposed amendments.

XI. Statutory Authority

Pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 9(h), 10, 11A, 15, 17(a), 17A, and 23(a) thereof, 15 U.S.C. 78b, 78c(b), 78i(h), 78j, 78k–1, 78o, 78q(a), 78q–1, 78w(a), the Commission is proposing amendments to §§ 242.200 and 242.203.

[179] 5 U.S.C. 603(c).

Text of the Proposed Amendments to Regulation SHO

List of Subjects 17 CFR Part 242

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, Title 17, Chapter II, part 242, of the Code of Federal Regulations is proposed to be amended as follows.

PART 242—REGULATIONS M, SHO, ATS, AC, AND NMS, AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

1. The authority citation for part 242 continues to read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k–1(c), 78*l*, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd–1, 78mm, 80a–23, 80a–29, and 80a–37.

* * * * *

2. Section 242.200 is proposed to be amended by adding new paragraph (g)(2) to read as follows:

§ 242.200 Definition of ''short sale'' and marking requirements.

* * * * *

(g) * * *

(2) For purposes of paragraph (g)(1) of this section, in determining whether the seller is ''deemed to own'' the security being sold, the broker or dealer must document the present location of the security being sold.

3. Section 242.203 is proposed to be amended by:

a. Revising paragraph (b)(3)(iii);

b. Redesignating paragraphs (b)(3)(vi) and (b)(3)(vii) as paragraphs (b)(3)(vii) and (b)(3)(viii);

c. Adding new paragraph (b)(3)(vi);

d. Removing the word ''and'' at the end of paragraph (b)(3)(vi); and

e. Amending newly designated paragraph (b)(3)(vii) by adding the word ''and'' after the semi-colon at the end of the paragraph.

The revisions and additions read as follows:

§ 242.203 Borrowing and delivery requirements.

* * * * *

(b) * * *

(3) * * *

(iii) *Provided, however,* that a participant of a registered clearing agency that has a fail to deliver position at a registered clearing agency in a threshold security on the effective date of this amendment and which, prior to the effective date of this amendment, had been previously excepted from the close-out requirement in paragraph (b)(3) of this section (*i.e.*, because the participant of a registered clearing

agency had a fail to deliver position in the threshold security that is attributed to short sales effected by a registered options market maker to establish or maintain a hedge on options positions that were created before the security became a threshold security), shall immediately close out that fail to deliver position, including any adjustments to the fail to deliver position, within 35 consecutive settlement days of the effective date of this amendment by purchasing securities of like kind and quantity;

* * * * *

(vi) If a participant of a registered clearing agency entitled to rely on the 35 consecutive settlement day close-out requirement contained in paragraph (b)(3)(iii) of this section has a fail to deliver position at a registered clearing agency in the threshold security for 35 consecutive settlement days from the effective date of the amendment, the participant and any broker or dealer for which it clears transactions, including any market maker, that would otherwise be entitled to rely on the exception provided in paragraph (b)(2)(ii) of this section, may not accept a short sale order in the threshold security from another person, or effect a short sale in the threshold security for its own account, without borrowing the security or entering into a bona-fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity;

4. Alternative 1: Alternatively, Section 242.203 is proposed to be amended by:

a. Revising paragraph (b)(3)(iii);

b. Redesignating paragraphs (b)(3)(vi) and (b)(3)(vii) as paragraphs (b)(3)(vii) and (b)(3)(viii);

c. Adding new paragraphs (b)(3)(vi) and (b)(3)(ix);

d. Removing the word ''and'' at the end of paragraph (b)(3)(vi); and

e. Amending newly designated paragraph (b)(3)(viii) by adding the word ''and'' after the semi-colon at the end of the paragraph.

The revisions and additions read as follows:

§ 242.203 Borrowing and delivery requirements.

* * * * *

(b) * * *

(3) * * *

(iii) The provisions of paragraph (b)(3) of this section shall not apply to the amount of the fail to deliver position in the threshold security that is attributed to short sales by a registered options market maker, if and to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on any options series in a portfolio that were created before the security became a threshold security;

(A) *Provided, however,* that if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a threshold security that is attributed to short sales by a registered options market maker, if and to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on options series that were created before the security became a threshold security, the participant shall close out the fail to deliver position, including any adjustments to the fail to deliver position, within 35 consecutive settlement days from the date on which the security became a threshold security by purchasing securities of like kind and quantity;

(B) *Provided, however,* that a participant of a registered clearing agency that has a fail to deliver position at a registered clearing agency in a threshold security on the effective date of this amendment which, prior to the effective date of this amendment, had been previously excepted from the close-out requirement in paragraph (b)(3) of this section (*i.e.*, because the participant of a registered clearing agency had a fail to deliver position in the threshold security that is attributed to short sales effected by a registered options market maker, if and to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on options positions that were created before the security became a threshold security), shall immediately close out that fail to deliver position, including any adjustments to the fail to deliver position, within 35 consecutive settlement days of the effective date of this amendment by purchasing securities of like kind and quantity;

* * * * *

(vi) If a participant of a registered clearing agency entitled to rely on the 35 consecutive settlement day close-out requirement contained in paragraph (b)(3)(iii) of this section has a fail to deliver position at a registered clearing agency in the threshold security for 35 consecutive settlement days, the participant and any broker or dealer for which it clears transactions, including any market maker, that would otherwise be entitled to rely on the exception provided in paragraph (b)(2)(ii) of this section, may not accept a short sale order in the threshold security from another person, or effect a short sale in the threshold security for its own account, without borrowing the security or entering into a bona-fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity;

* * * * *

(ix) To the extent that an amount of a fail to deliver position in a threshold security is attributed to short sales by a registered options market maker in accordance with paragraph (b)(3)(ii) of this section, a participant of a registered clearing agency and registered options market maker must document that the fail to deliver position resulted from short sales effected to establish or maintain a hedge on options series that were created before the security became a threshold security.

5. Alternative 2: Alternatively, Section 242.203 is proposed to be amended by:

a. Revising paragraph (b)(3)(iii);

b. Redesignating paragraphs (b)(3)(vi) and (b)(3)(vii) as paragraphs (b)(3)(viii)and (b)(3)(ix);

c. Adding new paragraphs (b)(3)(vi), (b)(3)(vii) and (b)(3)(x);

d. Removing the word ''and'' at the end of paragraph (b)(3)(vi); and

e. Amending newly designated paragraph (b)(3)(ix) by adding the word ''and'' after the semi-colon at the end of the paragraph.

The revisions and additions read as follows:

§ 242.203 Borrowing and delivery requirements.

* * * * *

(b) * * *

(3) * * *

(iii) The provisions of paragraph (b)(3) of this section shall not apply to the amount of the fail to deliver position in the threshold security that is attributed to short sales by a registered options market maker, if and to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on any options series in a portfolio that were created before the security became a threshold security;

(A) *Provided, however,* that if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a threshold security that is attributed to short sales by a registered options market maker, if and to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on options series that were created before the security became a threshold security,

the participant shall close out the fail to deliver position, including any adjustments to the fail to deliver position, by purchasing securities of like kind and quantity within the earlier of: 35 Consecutive settlement days from the date on which the security became a threshold security, or 13 consecutive settlement days from the last date on which all options series within the portfolio that were created before the underlying security became a threshold security expire or are liquidated;

(B) *Provided, however,* that a participant of a registered clearing agency that has a fail to deliver position at a registered clearing agency in a threshold security on the effective date of this amendment which, prior to the effective date of this amendment, had been previously excepted from the close-out requirement in paragraph (b)(3) of this section (*i.e.*, because the participant of a registered clearing agency had a fail to deliver position in the threshold security that is attributed to short sales by a registered options market maker, if and to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on options positions that were created before the security became a threshold security), shall immediately close out that fail to deliver position, including any adjustments to the fail to deliver position, within 35 consecutive settlement days of the effective date of this amendment by purchasing securities of like kind and quantity;

* * * * *

(vi) If a participant of a registered clearing agency entitled to rely on the exception to the close-out requirement contained in paragraph (b)(3)(iii)(A) of this section has a fail to deliver position at a registered clearing agency in a threshold security for longer than the earlier of: 35 Consecutive settlement days from the date on which the security became a threshold security, or 13 consecutive settlement days from the last date on which all options series within the portfolio that were created before the security became a threshold security expire or are liquidated, the participant and any broker or dealer for which it clears transactions, including any market maker that would otherwise be entitled to rely on the exception provided in paragraph (b)(2)(ii) of this section, may not accept a short sale order in the threshold security from another person, or effect a short sale in the threshold security for its own account, without borrowing the security or entering into a bona-fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity;

(vii) If a participant of a registered clearing agency entitled to rely on the 35 consecutive settlement day close-out requirement contained in paragraph (b)(3)(iii)(B) of this section has a fail to deliver position at a registered clearing agency in the threshold security for 35 consecutive settlement days from the effective date of the amendment, the participant and any broker or dealer for which it clears transactions, including any market maker, that would otherwise be entitled to rely on the exception provided in paragraph (b)(2)(ii) of this section, may not accept a short sale order in the threshold security from another person, or effect a short sale in the threshold security for its own account, without borrowing the security or entering into a bona-fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity;

* * * * *

(x) To the extent that an amount of a fail to deliver position in a threshold security is attributed to short sales by a registered options market maker in accordance with paragraph (b)(3)(iii) of this section, a participant of a registered clearing agency and registered options market maker must document that the fail to deliver position resulted from short sales effected to establish or maintain a hedge on options series that were created before the security became a threshold security.

* * * * *

By the Commission.

Dated: August 7, 2007.

Nancy M. Morris,

Secretary.

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