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April 13, 2010

Ms. Mary Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. S7-08-09 Amendments to Regulation SHO, Rule 201.

Dear Chairman Shapiro:

The Security Traders Association (STA) Options Sub-Committee (Committee) appreciates this opportunity to comment on the February 24, 2010 Final rule amendments to Regulation SHO Rule 201.

STA is a professional trade organization that works to improve the markets, ethics, business standards and working environment for all our members. With over 5,200 members across North America, all engaged in the buying selling and trading of securities, the STA provides a forum for our members to share their unique perspective on issues facing the securities markets. Our members work at the local affiliate level and national level to promote investor protection, increase transparency, and help foster the world's most efficient liquid markets. The STA Options Committee Sub-Committee is a key component of the STA Trading Issues Committee.

The committee is sensitive to the political pressures being brought to bear on the SEC in the advent of the 2008 financial crisis. And we believe no financial trade organization is more concerned about investor confidence and the impact that has on our industry. That being said we are troubled by the imposition of this rule without any "*short sale exemption for bona fide Market Makers*" and, *specifically* for Option Market Makers ("OMMs"). We understand the need for broad and comprehensive regulatory reform. But, SEC policies and rule making should encourage change and innovation that move our financial markets forward, and not burden them unnecessarily without empirical data to the contrary.

In July of 2007, after nearly 8 years of studying the issue, examining data from the Pilot, reviewing studies and analyses of its own economists and numerous independent economists, and considering the comments received in response to its proposals, the SEC eliminated short sale price restrictions. Three months later, the market made its historic highs and then the subprime mortgage and credit crisis' took hold. During the increased volatility and steep declines (particularly, in certain financial service firms at the center of the crisis), the media, investors and corporate heads and many others pointed to "unrestricted short selling" as a principal cause of these problems. In response, between July and October 2008, the SEC issued a series of emergency orders and adopted rules to address the possible role of 'abusive short selling' in the extreme drop in securities prices. Fortunately at the time, they did not reinstate price restrictions.

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As the SEC readily acknowledges, short selling provides the market with important benefits, including enhanced liquidity creation and improved pricing efficiency. Possibly no market is more sensitive to the need for efficient and cost effective hedging than the option market. Although, Commissioner Aguilar had commented on the potential impact of the rule, particularly on OMMs February 24th, stating "*that the SEC believes this risk is small do to the limited scope and duration of the rule. The Staff will monitor and make recommendations accordingly*". We believe there is a serious threat of unintended harm to one of the few markets (the U.S. Exchange Listed option market) that has functioned admirably well during the financial crisis.

Increasingly over the past 2 years, the U.S. Listed option exchanges have benefited from the migration of OTC derivatives and swaps to the more regulated and more transparent exchange markets. The SEC has often stated its interest in moving OTC derivative option and swap trading into the more transparent and regulated listed markets. However, without an OMM exemption it could be argued, more derivative and swap trading will move 'off exchange', where dealers can take advantage of hedge exemptions and craft contracts that bypass the restrictions. The unintended consequence would be less transparency and increased systemic risk as trading would move off the exchange floor to upstairs OTC desks.

On U.S. Listed option exchanges, OMMs must make 2-sided quotes in hundreds, if not thousands of series in multiple classes (equities, ETF and indices) in which they are assigned. By and large, the retail and institutional option customers that interact with those tight liquid quotes are 'takers of liquidity' from the multiple competitive venues. Meaning, the main strategies that most customers are engaging in: '*Put buying'* to protect an existing equity position or gain short market exposure or '*Call selling*' to enhance yield on an existing securities position must be effectively hedged. To facilitate customer orders with tight liquid 2-sided quotes, OMMs must be able to easily and cost effectively be able to hedge the 'directional' risk (Short Put/Long Call = synthetic long stock position) as they undertake customer facilitation. A triggered short sale restriction on a class would impact all the underlying series quoted by OMMs to the detriment of retail & institutional option customers. By disrupting the OMMs ability to hedge efficiently, quoted markets will widen and displayed liquidity will wither.

According to a study done by Paul Schulz and Robert Battalio (1) using data from the 2008 short ban (Sept.-Oct.), short sale restrictions "*affected the spreads of options on financial stocks*" negatively (widened). "*The impact of the short sale ban on quoted spreads is striking. In the 6 weeks prior to the ban, the coefficient on the banned variable was between $0.10 and $0.20. Dollar spreads were a little wider for financial stocks, but not much wider. On September 19th, the first day of the ban, the spread differences jumped to over $1.20. The spread differences remained" elevated "over $0.40 for the duration of the ban then slowly decline"* toward pre-ban levels (vs. a control group). Regression analysis using options with other expiration months yielded similar results. "*What is clear is it became much more expensive to trade both puts and calls when the ban on shorting the underlying stock was implemented*". Spreads were widest on September 19th 2008, at the height of confusion and, most importantly, when OMMs *were to be included in the short sale ban and would be unable to short the banned securities*.

The same study also illustrated the impact on liquidity. The average ratio of relative effective to relative quoted was 100% on the banned stocks prior to the emergency order. What this means is that the average liquidity taking customer paid 100% of the quoted bid/ask spread. In a control group, liquidity taking customers paid 98.4% (indicating more liquidity available to fill the order). On the day SEC imposed Rule 204T, the ratio of effective quoted relative to the bid/ask grew to 109% for options in the banned securities. On September 19th (when OMM were also to be restricted from short selling), this ratio explodes to 137% for stocks on the restricted list. According to Schulz and Battalio (2).."*our analysis of quoted spreads understates the impact of the short sale ban on investors seeking to trade options on banned stocks during the short* (higher Put offers & lower Call bids). There is evidence suggesting "*that regulatory uncertainty led to wider bid/ask spreads for all options*" Intuitively this would make sense as the uncertainty of “who is next?” (In a sector, industry, and index) would increase the dislocation risk and widen spreads to mitigate the increased perceived risks (of an OMM being unable to dynamically re-hedge an existing position). OMMs will gradually build into their quoting “*extra price insurance to compensate for the perceived risk to directional hedging by moving the price of call bids lower and put offers higher*.” If the OMM quoting in a restricted class did not have stock in inventory to hedge their risk, his ability to quote a tight two-side market is impaired. Market quality would suffer illustrated by wider spreads and less displayed liquidity. Limiting an OMM’s ability to easily and efficiently hedge, damages an OMM quote making ability.

We further agree with the Commission that Rule 201 will be successful in inhibiting short sales when triggered, but we also know it will impact liquidity and market pricing efficiency even *prior* to it being triggered. OMM must manage hundreds, if not thousands of series on the underlying classes that make up their inventory position book. Option position risk is not static and must be dynamically re-hedged as the underlying security moves, volatility changes, time decays and other variables. The ability to re-hedge an existing position adds a new risk that must be priced into an OMM’s quotes. Additionally, as the trigger is approached, ‘over hedging (or pre-hedging)’ could exacerbate a stock decline, increasing volatility and the need for further hedging an existing position. Wider quotes and less liquidity would be the natural consequence.

In Summary:

The STA Options Committee Sub-Committee strongly recommends to the Commission that it reevaluates Rule 201 to include an exemption for bona fide OMMs on U.S. Listed option exchanges.

Sincerely,

Rory O’Kane	Christopher Nagy	David Mortimer
Knight Capital Group	TD Ameritrade	Pipeline Trading

Co-Chairmen,
STA Options Sub-Committee

cc: SEC Secretary Elizabeth M. Murray
SEC Commissioner Kathleen L. Casey
SEC Commissioner Elisse B. Walter
SEC Commissioner Luis A. Aguilar
SEC Commissioner Troy A. Paredes
Robert W. Cook, Director, SEC Division of Trading and Markets
James Brigagliano, Deputy Director, SEC Division of Trading and Markets

(1) “Regulatory Uncertainty and Market Liquidity: The 2008 Short Sale Ban’s Impact on Equity Option Markets”, Prof. Robert Battalio and Prof. Paul Schulz, Univ. of Notre Dame, draft Sept. 30, 2009.

(2) The effective-quoted ratio compares the average ‘effective spread’ with the ‘quoted spread’. An Effective/Quoted ratio of 100% means that the effective spread and the quoted spread were the same and the order was executed at the NBBO. The lower the ratio, the lower the execution cost to the customer.