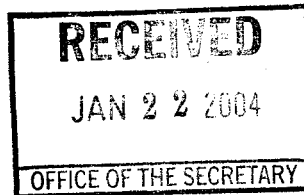




Edward J. Joyce
President and
Chief Operating Officer

Phone: 312 786-7310
Fax: 312 786-7407
joyce@cboe.com



321

January 20, 2004

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street N.W.
Washington, D.C. 20549-0609

Re: Proposed Regulation SHO (Release No. 34-48709; File No. S7-23-03)

Dear Mr. Katz:

The Securities and Exchange Commission ("SEC" or "Commission") has published for comment proposed Regulation SHO and Rules 201, 202 and 203 thereunder, which concern the regulation of short sales of certain securities. The Chicago Board Options Exchange, Inc. (the "CBOE" or "Exchange") is submitting this letter to express its views concerning the Commission's proposals, where such proposals significantly relate to the listed options markets.

The Exchange has summarized below certain suggested modifications to the Commission's proposals, which are critically needed in order to ensure the ongoing health and effectiveness of the listed options markets. This summary is followed by more detailed explanations and supporting arguments.

SUMMARY

Proposed Rule 201 – Consolidated Bid Test. The SEC must provide an options market-maker hedge exemption.¹

- For market participants other than options market-makers, the Exchange believes that the proposed bid test is preferable to the current price restrictions on short sales. The proposed bid test would not provide sufficient flexibility to permit efficient hedging by options market-makers. Unlike stock specialists and market-makers, options market-makers do not have the ability to sell stock on the offer, but must place orders that generally result in a sale of stock at no greater price than the disseminated bid.
- The lack of a hedge exemption that allows options market-makers to efficiently effect short sales in stocks underlying the options in which they make markets results in higher costs to public investors.
- The role of an options market-maker differs from that of a stock specialist or stock market-maker. Stock specialists and stock market-makers trade to manage an inventory that could, at times, be net short and positively affected by a downward move in the price of the stock.

¹ The term options market-maker is inclusive of such other terms as Designated Primary Market-Maker ("DPM"), Options Specialist, and any other such term used to refer to a person or entity that performs a market-making/specialist function in options listed on a national securities exchange.

Options market-makers assume stock positions to hedge the option positions in which they make markets, in an effort to remain market neutral.

- Options market-makers have no incentive to force the price of a stock lower. Doing so when trying to establish a hedge would result in an inferior hedge. In the case of an existing hedge, any gain on the short stock would be offset by a loss on the long market exposure in options.
- The Exchange strongly urges the Commission to modify its bid test proposal to include a hedging exemption for options market-makers when selling stock short to hedge the risk exposure of options positions in any options class obtained in the course of performing legitimate market-making functions, and to adopt such an exemption from the current tick test, for as long as the tick test remains in effect.²
- This need is particularly critical, given that proposed Rule 201 not only contemplates maintaining short sale price restrictions for options market-makers in listed stocks, but also the withdrawal of the existing exemption from price restrictions on short sales in NASDAQ stocks for the hedging of options market-maker exposure.
- The existing options market-maker short sale exemption from price restrictions in NASDAQ stocks has functioned well from a regulatory standpoint and should continue.
- CBOE strongly believes that a hedge exemption such as previously proposed by the CBOE would not pose any undue burden on the markets for securities underlying listed options or on the stock specialists.
- The Commission has and is supporting other exemptions from short sale price restrictions that arise from needs very similar to those of the options market-maker. The block positioner exemption is proposed to be continued by the Commission, as is an exemption for index arbitrage liquidations. These exemptions serve as a strong precedent for the granting of an options market-maker hedge exemption.
- Adequate self-regulatory surveillance will provide for early detection and appropriate discipline of violations of hedge exemption provisions and for general overall compliance with such provisions.

Proposed Rule 202 -- Pilot Suspending Bid Test for Certain Stocks.

Proposed pilot is too limited and would create inappropriate competitive disparities in the trading of comparable securities.

The Exchange first and foremost urges the Commission to adopt an options market-maker short sale hedge exemption from any and all price restrictions. Additionally, in respect of all market participants, the Exchange concurs that it is also reasonable to permit short sales in highly liquid securities to be effected on a pilot basis exempt from price restrictions. However, the Exchange has several serious concerns with the pilot as proposed by the Commission.

² The Exchange has proposed on numerous occasions that the Commission permit at least on a pilot basis an options market-maker hedging exemption from short sale restrictions. See letters from the CBOE to Richard R. Lindsey – SEC, dated April 6, 1998 (draft); to Annette L. Nazareth – SEC, dated August 22, 2000; to Annette Nazareth, dated August 20, 2001; and to Jonathan G. Katz, Secretary – SEC (regarding the SEC's short sale concept release), dated December 27, 1999.

- The proposed number of exempt pilot stocks is too small.
- The Exchange is concerned that it may not be practical under the proposed pilot provisions to determine with any degree of certainty what trading differences may be attributed to a stock's being subject to the bid test and another's being exempt. It would seem more beneficial to study the unrestricted short selling of a more meaningful number of securities, all of which meet certain minimum standards of capitalization, trading depth and liquidity.³
- The Commission already has access to substantive data on short sales of NASDAQ NMS stocks where limited exemptions to the current NASD bid test are permitted such as those for stock and options market-makers. The CBOE is aware of no short sale abuses having occurred by market-makers.
- Placing price restrictions on the short sale of some securities and exempting other comparable securities from those same price restrictions would be unfair and burdensome to those trading the non-exempt securities.

Proposed Rule 203 -- Locate and Delivery Requirements.

Options market-makers must not be impeded or penalized from selling stock short to hedge legitimate options market-maker risk exposure even where there exists an inability to deliver stock.

- The Exchange supports the Commission's intention to continue to exempt market-makers generally from the otherwise mandatory pre-locate and delivery requirements of proposed Rule 203.
- The Commission's proposed pre-borrowing requirements for stocks subject to certain delivery failure thresholds are impractical. The Commission's proposal does not address certain practical complications, and may result in unintended and undue burdens upon clearing firms and their customers, as explained further in the body of this letter. Most notably, it is highly impractical, if not impossible, to assign the "fault" for any delivery failure to a particular clearing firm customer account.
- The Exchange can unequivocally state that the arguments presented in the release concerning the appropriateness of these restrictions to short selling by stock specialists and stock market-makers are clearly not applicable to options market-makers. As further explained in the body of this letter, options market-makers should be and must be exempted from any mandatory pre-borrowing requirement when selling stock short to hedge legitimate market-making functions.

* * * * *

Proposed Rule 201 – Consolidated Bid Test.

Proposed Rule 201 would require that all short sales in securities subject to the current SEC Rule 10a-1 "tick test" and those subject to the current NASD Rule 3350 "bid test" be required to be

³ An example of such a group of securities would be all those included in the two highest position limit tiers for listed options.

effected at a price at least one penny above the consolidated best bid. The Exchange believes that the bid test as proposed is preferable to the current price restrictions on short sales.

No market-maker or hedge exemption from this new bid test is contemplated. However, the CBOE believes that the SEC has demonstrated legitimate concern and care in requesting comment on situations in which such exemptions may be appropriate. As stated earlier, the CBOE is intentionally limiting its comments to issues that are directly and significantly concerned with the health and effectiveness of the listed options markets. Our silence on whether or not a bid test exemption should be afforded under any circumstances to stock specialists and market-makers, or to other market participants for legitimate hedging, should not be misconstrued as an objection to such ideas generally. CBOE, however, may comment in the future upon any specific proposals for such exemptions.

The SEC Must Provide an Options Market-Maker Hedge Exemption.

The Exchange strongly urges the Commission to modify its bid test proposal to include a hedging exemption for options market-makers when selling stock short to hedge the risk exposure of options positions undertaken in the course of performing legitimate market making functions.⁴

This is particularly critical, given that proposed Rule 201 not only contemplates maintaining short sale price restrictions for options market-makers in exchange listed stocks, but also the withdrawal of the existing exemption from price restrictions on short sales in NASDAQ stocks for the hedging of options market-maker exposure. The CBOE urges the Commission to retain an options market-maker hedge exemption from short sale price restrictions in NASDAQ stocks. The options market-maker hedge exemption for NASDAQ short sales has not resulted in any substantive regulatory concerns in the approximately nine years of operation.⁵ The Commission in its Release has not articulated any reasons for eliminating the options market-maker exemption. The CBOE is aware of no legitimate basis for taking such action; to do so will critically damage the options markets.

In addition to an options market-maker hedge exemption from the proposed bid test, the CBOE strongly recommends that the SEC adopt an options market-maker hedge exemption from the current tick test for as long as the tick test remains in effect.

The Commission has and is supporting other exemptions from short sale price restrictions that arise from very similar needs to those of the options market-maker. The block positioner exemption is again being proposed by the Commission, as is an exemption for index arbitrage liquidations. These exemptions serve as a strong precedent for the granting of an options market-maker hedge exemption.

A hedge exemption for the sole purpose of managing the risk exposure of legitimate options market-making is severely limited, and does not pose any undue burden on the markets for securities underlying listed options or on the stock specialists and market-makers. Adequate self-

⁴ See footnote number 2.

⁵ The NASD's options market-maker exemption was first approved by the Commission on Tuesday, September 6, 1994. Short sales are eligible for a bid-test exemption if the stock underlies options to which the market-maker holds an appointment, the short sale hedges pre-existing or contemporaneously established option positions, and the stock position is eligible for good-faith margin treatment.

regulatory surveillance will provide for early detection and appropriate discipline of violations of hedge exemption provisions and for general overall compliance with such provisions.

The Basis for an Options Market-Maker Hedge Exemption

The reasons for a short sale exemption for options market-makers has been expressed in previous letters to the Commission from both the CBOE and The Pacific Exchange.⁶ Foremost among the many reasons for an exemption are the following:

- **Cost of Inability to Efficiently Hedge With a Short Sale is Borne By Investors** -- The current short sale tick test significantly impedes efficient hedging activity by options market-makers, thereby restricting their ability to perform their market-making functions. When options market-makers are unable to hedge with a short sale of stock because they must wait for an uptick, the risk to the market-maker is increased. Reduced ability to hedge also exposes the options market-maker clearing firm to greater risk. We believe that the proposed bid test does little to reduce this exposure. The Exchange believes that efficient hedging in underlying securities by options market-makers cannot take place under the proposed bid test. To compensate for this risk, options market-makers must lower their bid and/or raise their ask prices, and/or reduce their available size, thereby lowering the quality of options markets. Thus, the associated costs and delays of hedging are often borne by investors. An options market-maker exemption for hedging with short sales of listed stocks will increase depth and liquidity in the options markets, reduce risk to options market-makers in assuming options positions and foster better executions for the public and other investors without increasing the risks the short sale rule was designed to prevent. An exemption from the proposed bid test is in the public interest. Public customer option orders can be executed more timely and at better prices if options market-makers were permitted to sell stocks short for hedging purposes without price restriction. Maintaining such an exemption for NASDAQ stocks will continue to provide the same benefits.

- **Options Market-Makers Must Maintain Positions** -- In its Release the Commission notes that “most specialists and market-makers seek a net “flat” position in a security at the end of each day and often “offset” short sales with purchases...” An end of day “flat” position for an options market-maker would be highly unusual. Ideally, an options market-maker would like to attain a “synthetically flat” or otherwise delta neutral stance by balancing the long and short market exposures of the various options series in a particular options class. In simple terms, a typical listed options class is comprised of multiple call and put series with various strike prices and expiration dates that most often trade in a more or less predictable relationship to the underlying stock and to each other. The many possible different series combinations provide the options user with a host of “synthetic” ways in which to take a position “in the stock”, whether the user holds a bullish, bearish, or neutral market opinion, with a near-term, mid-term or long-term market outlook, or prefers a net debit (purchase) or a net credit (sale) transaction. As a result, options market-makers may have positions in many, if not all, of the options series in an appointed class. Even though they may not have a net long stock position, options market-makers incur similar long exposure when they have to buy calls and/or sell puts. Open interest in options classes/series is often very one sided, with

⁶ See footnote number 2 and letter from The Pacific Exchange to Richard R. Lindsey – SEC, dated March 3, 1998.

all appointed market makers maintaining positions largely on one side of the market or the other, sometimes in options series of very long duration (i.e., LEAPS.). In such a situation it may be difficult for the market-maker to liquidate or hedge his net long side options position with other offsetting options, because other market-makers are also trying to manage long side exposure and/or public order flow is on the sell side. The only possible action is hedging in the underlying stock.

- **Market-Maker Obligations Are Basis for Exemption --** The rules of the SEC and the options exchanges impose many affirmative obligations on options market-makers. The most significant of these is the firm quote requirement, which provides that the market-maker must post a bid, offer and size for every options class/series at his post, and honor the resulting disseminated quotation. The spread between the bid and offer may not exceed set limits. In general, options market-makers are required to maintain fair and orderly markets and, as necessary, engage in dealing for their own accounts to foster price continuity, balance supply of and demand for a particular option contract, and maintain appropriate price relationships between options of the same class. Because of the importance of their market functions, options market-makers are exempt from many of the SEC's financial and record keeping requirements, as well as from the margin requirements of Regulation T. Likewise, because these market functions significantly benefit investors, it is important that options market-makers be able to effect short sales to hedge the risk of providing them without being constrained by price restrictions.
- **Firm Quote Compliance Undermined by Bid Test--** Options market-makers are obligated to honor their disseminated quotes. The quote for each options series in a class is related to, among certain other factors, the price of the underlying stock and the prices of the other series in the class. Options market-makers use many execution services and access all of the available markets for underlying securities in order to meet their hedging needs. To reduce the risk of inefficient stock executions, options market-makers generally avoid the use of market orders and tend to enter stock limit orders. Under any form of short sale price restriction, options market-makers are forced to cancel and replace numerous stock orders in a tedious, costly and time consuming process of chasing the ever-changing bid and/or last sale price. The inability to immediately "hit the bid" in a stock in order to hedge has a significant and detrimental impact upon the risks undertaken by the market-maker in honoring his disseminated quotes. Moreover, the frequency of order cancels and replacements has the potential to clog the system with unnecessary traffic.
- **Precedent Exists in Exemptions for Block Positioners and Index Arbitrageurs --** The Commission notes in its Regulation SHO proposing release that a block-positioner that also engages in arbitrage using convertible securities, rights, warrants or call options has no incentive to cause or accelerate a decline in the market by liquidating a long stock position when all of its short positions in the same stock are part of an arbitrage (e.g., short stock / long call options), even if the sale of stock would result in a net short position. The Commission recognizes the arbitrage as a neutral position and that there is no advantage in establishing a new short stock position because that short position would offset with the long stock position. Therefore, the long position is considered separate and distinct from all other (hedged) stock and such block-positioners are afforded an exception from the "tick" restrictions of SEC Rule 10a-1 when selling the unhedged long position.

A similar exception is afforded to index arbitrage positioners through no-action relief. SEC Rule 10a-1, and the no-action relief pertaining to index arbitrage, effectively allow option positions to be included in the determination of whether the block-positioner or index arbitrageur has a net-short or net flat position in a stock. Thus, long options are recognized as offsets to short stock for purposes of computing the net stock position.

The Commission is proposing to maintain the current exemptions from short sale price restriction for the block positioner, and for the index arbitrageur. The Commission's reasoning is directly applicable to the hedging needs of the options market-maker. Certainly, the options market-maker's role in maintaining fair and orderly markets is no less important than that of the block-positioner. In the course of fulfilling his market-maker obligations, the options market-maker often holds a synthetically net long position in a combination of options series that are impractical to liquidate or to hedge with other offsetting options. Not only would the market-maker not benefit from a downward move in the underlying stock, he most assuredly would be harmed. In selling stock short only to neutralize his long exposure, the options market-maker continues to have no incentive or reason to benefit from a downward move in the stock. Like the block-positioner and the index arbitrageur, the options market-maker's long market exposure in options should be recognized as offsetting and neutralizing the market exposure of any short stock position, and therefore as providing no opportunity to benefit from any decline in the price of the stock sold short.

- **Options Market-Makers Don't Have Ability to Sell Stock at the Stock's Offer Quotation** -- In its proposal the SEC states that one reason for denying any market-maker exemption to the proposed bid test, is that stock market-makers sell at the offer and buy at the bid, so would almost never need to sell short at the bid. Unlike stock specialists and market-makers, options market-makers do not have the ability to sell stock on the offer, but must place orders that generally result in a sale of stock at no greater price than the disseminated bid. Having to sell even at one penny above the bid may seriously delay the options market-maker's ability to hedge on a timely basis or at all.
- **Options Market-Maker Stock Activity Limited to Hedging** -- The exemption CBOE proposes is solely limited to hedging, and as such could be utilized only when selling stock short to hedge the long market exposure of options positions undertaken as a result of options market-making activity. There would be regulatory consequences for misusing the exemption for speculative purposes. Moreover, it is highly unlikely that options market-makers will engage in speculative stock trading, because they risk violating margin and net capital regulations, or the imposition of additional, onerous requirements. Notwithstanding any short sale "tick" (or "bid") test exemption, options market-makers must confine their stock trading activity to hedges against options positions established in their market-making capacity. Therefore, any gains on a short stock position would be offset by losses from long market exposure in options, leaving an options market-maker with no motive to engage in speculative short selling to drive the price of the stock down.
- **Short Sales of Options Market-Makers Are Not Significant Relative to Outstanding Shares or Float** -- Exempt short selling by options market-makers as a percentage of the total number of shares outstanding or float would be small, and would not reach a level of short sales that could justify concerns about manipulation. Options market-makers, for the most part, strive to maintain a neutral market exposure, and therefore, it is common practice to

hedge on a delta-equivalent basis. This generally results in stock hedges of less than 100 shares per option contract. Additionally, options market-makers in general tend to use stock hedges as a measure of last resort, so that if possible, liquidation or offsets with other options contracts typically would be utilized before short sales of the underlying stock.

- **No Difficulties with Options Market-Maker NASDAQ Exemption** -- Market-makers in options overlying NASDAQ stocks are exempt from the NASD's minus and zero minus bid test prohibitions when shorting the stock in order to hedge option transactions in their appointed classes. The options market-maker exemption to the NASD's short sale rule has not resulted in any cause for concern. The Commission has found the options market-maker exemption for short sales of NASDAQ stocks to "facilitate transactions in securities and to protect investors and the public interest".⁷ The Commission has provided no reasons supporting the elimination of this exemption. Furthermore, we are aware of no significant regulatory matters involving short sales on electronic communications networks (ECNs) or regional exchanges, where no short sale price restrictions whatsoever are imposed.
- **Adequate Surveillance** -- Current surveillance procedures provide that if an options market-maker sells a NASDAQ stock based upon an exemption from the NASD short sale rule, he or she would be subject to appropriate regulatory or disciplinary action if not entitled to use the exemption. Similar procedures would be developed and implemented for application to exchange listed securities.
- **Stock Specialist Hedge with No Price Restrictions** -- When stock specialists hedge their risk by using options, they are not constrained by a short sale rule if they wish to sell calls or puts. If stock specialists have unfettered ability to establish short option positions for hedging purposes, options market-makers should have equally unconstrained ability to sell stock short for hedging purposes. It is only fair that options market-makers be able to sell stock short to hedge without having to contend with a price restriction if they are exposed to hedging transactions by stock specialists.
- **Exemption Maintains Proper Balance** -- An options market-maker exemption would facilitate a proper balance between regulation that may be necessary to prevent abusive short selling and rules that inappropriately restrict short selling activity that promotes pricing efficiency and liquidity.

Index Options Market-Maker Hedge Exemption.

The focus of the Exchange's comments is the hedging needs of equity options market-makers. The ability to hedge index options transactions by selling stock short pursuant to an exemption is not as critical due to the availability of exchange traded index funds corresponding to the most popular indexes. Shares of the subject index funds may be sold short without regard to price restriction pursuant to a Commission no-action letter. We understand from the Commission's Regulation SHO proposing release that it intends to continue to apply the previously granted relief, and we concur that this is appropriate. However, it may be necessary and appropriate to

⁷ See Securities Exchange Act Release Nos. 37492 (July 29, 1996) - 61 FR 40693 (Aug. 5, 1996), 37917 (Nov. 1, 1996) - 61 FR 57934 (Nov. 8, 1996)

provide a hedge exemption from short sale price restriction to index options market-makers, as a corresponding exchange traded fund does not exist for every index.

We, therefore, ask that the Commission allow an opportunity for an index option market-maker hedge exemption to be discussed further. Additionally, the Exchange urges the Commission to maintain the index option market-maker hedge exemption from short sale price restriction in NASDAQ stocks.⁸

Circuit Breakers.

The Commission notes in its Regulation SHO proposing release that the rules of exchanges provide for implementation of coordinated circuit breaker trading halts. In that regard, the Commission is seeking comment as to whether short selling should continue to be restricted in response to a severe market decline. Without regard to other issues or concerns that may pertain to the operation of circuit breakers, the Exchange believes it is important to make this point here. Whenever options markets are open for trading it is imperative that options market-makers be permitted to sell stock short to hedge. Even in situations where the Commission may believe it is necessary and appropriate to curtail short selling generally, options market-makers should be exempt from any such restrictions when selling stock for the purpose of hedging legitimate market-maker activity.

Proposed Rule 202 -- Pilot Suspending Bid Test for Certain Stocks.

The SEC proposes to select approximately one third (300) of the Russell 1,000 stocks for this pilot and to select other stocks, as the Commission may deem necessary or appropriate. The SEC believes that both samples (pilot stocks exempt from the bid test and pilot stocks subject to the bid test) should include exchange listed and NASDAQ stocks, optionable stocks, stocks with associated securities futures, and both value and growth stocks. The SEC believes that the two pilot groups should contain comparable securities. The SEC has asked whether the proposed selection method might benefit one market over another.

Proposed Pilot is Too Limited and Would Create Inappropriate Competitive Disparities in the Trading of Comparable Securities.

The Exchange is convinced of the necessity for an options market-maker hedge exemption from short sale price restrictions. Further, the Exchange believes that this exemption should be established as soon as practical and without regard to other changes that the Commission may or may not implement with respect to short sales of stock. Nevertheless, the Exchange concurs that it is reasonable to permit short sales in highly liquid securities to be effected on a pilot basis exempt from any and all price restrictions. The Exchange has several serious concerns with the pilot as proposed by the Commission.

- The proposed number of exempt pilot stocks is too small, particularly where no hedging exemption is intended at least minimally for managing the risk exposure of options market-makers.

⁸ Currently, index options market-makers may sell NASDAQ stocks short without price restriction to hedge index options transactions pursuant to specific exemption provisions under the rules of the NASD.

- There may be many reasons why ostensibly comparable stocks might trade differently from each other. The Exchange is concerned that it may not be practical under the proposed pilot provisions to determine with any degree of certainty what trading differences may be attributed to a stock's being subject to the bid test and another's being exempt. It would seem more beneficial to study the unrestricted short selling of a more meaningful number of securities, all of which meet certain minimum standards of capitalization, trading depth and liquidity.⁹ As the pilot demonstrates certain results over some reasonable time frame and under the initial pilot standards, the Commission could then propose to broaden or further limit the standards for securities subject to unrestricted short sales as appropriate.
- The Commission already has access to substantive data on short sales of NASDAQ NMS stocks where limited exemptions to the current NASD bid test are permitted such as those for stock and options market-makers. The CBOE is aware of no short sale abuses having occurred by market-makers.
- Placing price restrictions on the sale of some securities and exempting other comparable securities from those same price restrictions would impose an unfair disadvantage on both stock and options market-makers and specialists responsible for maintaining orderly markets in the price restricted securities or their overlying options.

Proposed Rule 203 -- Locate and Delivery Requirements.

Proposed Rule 203 is similar in some respects to existing SRO rules, but is more stringent. Proposed Rule 203 would require all broker-dealers, for both proprietary and client accounts, to have "reasonable grounds to believe" the security could be borrowed before permitting the short sale to be effected. The SEC proposes to continue the market-maker exemption from this provision.

However, the SEC is proposing a mandatory delivery requirement of settlement date plus two days ("S+2") for any security where the delivery failures to a registered clearing agency total 10,000 shares or more, and are equal to at least one half of one percent of the security's shares outstanding (i.e., if $\frac{1}{2}$ of 1% of shares outstanding is less than 10,000 shares, then the threshold is 10,000 shares; if the percentage is more than 10,000 shares, then the threshold equals the higher number of shares.)¹⁰ If a delivery in such a security is not made within S+2, the short seller, including a market-maker, will be subject to pre-borrowing in that security before any additional short sales for a period of 90 calendar days. Further, the clearing agency would be required to refer such failures to the NASD and to the failing broker-dealer's DEA for monitoring and possible disciplinary action.

Allocation of Fails to Individual Accounts is Impractical.

The complex process of continuous net settlement, the delivery time frames for options exercises and assignments, and the ability of stock lenders to demand the return of their stock without any warning, each may result in delivery failures that are not related at all to naked short selling or to non-compliance with pre-locate or delivery requirements. The Commission's proposal does not

⁹ An example of such a group of securities would be all those included in the two highest position limit tiers for listed options.

¹⁰ This is the delivery threshold currently applicable in NASD Rule 11830. NSCC currently tracks this information for all of its securities.

address these complications, and may result in unintended and undue burdens upon clearing firms and their customers.

As the Commission is aware, generally short sellers do not arrange for borrowing or delivery of securities against a short sale. This is the province of the clearing firm, and, with the exception of clearing firm proprietary trading, the clearing firm is acting as an agent and not as a principal. In general, the clearing firm has every incentive to borrow stock and make delivery against the short sales of its customers. Short stock rebates are one incentive. Net capital charges and customer reserve formula penalties for fails to deliver are others. Moreover, SRO rules require clearing firms to be reasonably confident that the stock can be obtained for delivery prior to effecting short sales for customers, although short sales of market-makers are exempt from these affirmative determination requirements.

Even so, a clearing firm may not be successful in settling "net long" at the clearing house. This can occur for many reasons totally unrelated to the clearing firm's diligence in locating and borrowing stock. Stock lenders may demand the return of their previously loaned stock; clearing firm clients may sell their long margin securities that have been "internally borrowed" to make delivery on previous short sales of other clearing firm clients; or customers may exercise and/or be assigned on option positions that result in the posting of stock sales to their account. Any one or more of these events may result in the clearing firm failing to make delivery in a stock to the clearing corporation. None of these events is associated with naked short selling or with failures to follow pre-locate requirements.

Further, the benefits of common clearing and the CNS system make it possible to deliver into the clearing house the clearing firm's net long or short position in a stock without regard to various borrow/loan arrangements, or the specific underlying transactions and customer accounts that may hold long and/or short positions in the stock. In the CNS environment it certainly is not practical, if not impossible, to assign the "fault" for any delivery failure to a particular clearing firm customer account.

The Commission's proposal does not admit the complexities of the CNS system; nor does it provide for "no-fault" delivery failures such as those described above. The harsh consequences of a 90-day freeze on short sales as well as potential disciplinary actions would be unjust were these important issues not appropriately addressed. We ask that the Commission reconsider the effect these issues would have on clearing firms and their customers under the Commission's proposed Rule 203.

Likewise, the proposed S + 2 delivery requirement is impractical. It provides insufficient time in which to purchase stock for guaranteed delivery or to exercise options in order to obtain securities for delivery in situations where, for any number of legitimate reasons, a prior responsible arrangement for obtaining the stock has failed. We request that the Commission adopt the current 10-day time frame and continue to study whether a different time frame should be adopted in the future.

Options Market-Makers Must Not Be Impeded or Penalized From Selling Stock Short to Hedge Legitimate Options Market-Maker Risk Exposure Even Where There Exists an Inability to Deliver Stock.

The Exchange supports the Commission's intention to continue to exempt market makers generally from the otherwise mandatory pre-locate and delivery requirements of proposed Rule 203¹¹. However, the Exchange has several concerns.

The CBOE is not in a position to comment concerning the soundness of the Commission's reasons for imposing mandatory pre-borrowing and delivery requirements upon stock specialists and stock market-makers when there exists certain threshold delivery failures. However, the Exchange can unequivocally state that the reasons as given by the SEC for imposing such restrictions upon stock specialists and stock market-makers are clearly not applicable to options market-makers. Options market-makers should and must be exempted from any mandatory pre-borrowing and delivery requirements when selling stock short to hedge legitimate market-making functions.

In its Release the SEC states:

“Finally, although market makers engaged in bona fide market making are currently exempt from NASD Rule 11830 [mandatory delivery], we believe that extended failures to deliver appear characteristic of an investment or trading strategy, rather than being related to market making. We believe it is questionable whether a market maker carrying a short position in a heavily shorted security for an extended period of time is in fact engaged in providing liquidity for customers, or rather is engaged in a speculative trading strategy. Therefore, we are not proposing an exception from these additional delivery requirements for short sales in connections with market making.”

While the CBOE cannot comment as to whether the Commission's concerns as quoted above are warranted, the same concerns cannot be asserted for short stock positions held by options market-makers. Short sales by options market-makers are not permitted for speculative trading, but are limited to legitimate hedging of options market-making activity. Any short sale / mandatory delivery exemption notwithstanding, it is highly unlikely that options market-makers would engage in non-hedge stock activity due to possible regulatory consequences (e.g., margin and net capital), as previously explained.

It is quite common, and in fact very necessary, for options market-makers to continue to maintain a stock hedge for many months, particularly where LEAPS® form part of the exposure.¹² Without the stock hedge, the options market-maker's risk position would seriously deteriorate, exposing the market-maker and his clearing firm to unwarranted potential for loss. The extended maintenance of short positions is not indicative of a speculative trading strategy, but is directly related, and absolutely necessary, to providing liquidity for customers in the overlying options.

Regarding the general provisions for pre-location of securities subject to short sales, the Commission stated in its Release that “a narrow exception for market makers and specialists engaged in bona fide market making activities is necessary because they may need to facilitate customer orders in a fast moving market without possible delays associated with complying with the proposed ‘locate’ rule.” The Commission's underlying reason for proposing the general exemption for specialists and market-maker's is even more applicable to options market-makers

¹¹ Interpretation .01 (found in the NYSE's Interpretation Handbook) to NYSE Rule 440C and CBOE Rule 30.20, Interpretation and Policy .04, exempt short sales by market-makers from the locate requirement.

¹² LEAPS are long term options having expiration dates of up to 39 months in the future.

responsible for making markets in options overlying "hard-to-borrow" securities that become subject to the proposed delivery failures threshold. It is in just such situations that the options market maker most needs to hedge his legitimate market-making activity with short sales of the underlying security. Without the ability to hedge through short sales of the underlying security, the options market-maker most certainly would increase the width of his spreads and decrease the size of his quotations drastically, or exposed himself and his clearing firm to unacceptable levels of risk.

We do not believe that the SEC has provided any legitimate reasons for eliminating the options market-maker exemption from the mandatory pre-borrow and delivery requirements proposed for securities meeting certain delivery failure thresholds. To impose such requirements on options market-makers in a "hard-to-borrow" stock would make it impossible for the market-maker to fulfill his obligations, totally disrupt the market for the overlying options, and place stress on the clearing system in general. We respectfully request that the SEC reconsider its proposal and continue to exempt options market-makers from any requirements to pre-borrow these delivery failure threshold securities before effecting short sales to hedge legitimate market-making activity.

Conclusion

The Exchange values this opportunity to once again present its views concerning the Commission's short sale requirements. The Exchange strongly urges the Commission to provide for an options market-maker exemption from both the short sale price restrictions and the pre-borrowing requirements of proposed Regulation SHO and corresponding rules, and to modify the scope of its proposed pilot to study the effects of unrestricted short sales in selected highly liquid stocks.

The CBOE offers its full, continued support of the Commission's efforts in pursuing these much needed changes to the regulation of short sales. Should you have any comments or questions concerning the Exchange's comments, please contact Richard Lewandowski at (312) 786-7183.

Sincerely,



Edward J. Joyce

cc: Timothy Thompson - CBOE
Richard Lewandowski - CBOE
Joanne Moffic-Silver - CBOE
Christopher Hill - CBOE