The Chicago Stock Exchange

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VIA EXPRESS MAIL

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

Re: Proposed Rule Release Requesting Public Comment Regarding Regulation of Short Sales of Securities Release No. 34-48709; File No. S7-23-03

Dear Mr. Katz:

The Chicago Stock Exchange the "CHX" or the "Exchange" is submitting this letter in response to the Commission's request for public comment regarding proposed rules regarding the regulation of short sales of securities (the "Short Sale Rule Proposal"). In particular, the CHX wishes to address the subject of proposed new Regulation SHO under the Securities Exchange Act of 1934 (the "Exchange Act"), which would replace Exchange Act Rules 3b-3, 10a-1 and 10a-2, commonly referred to collectively as the "short sale rule." The Exchange also wishes to address the Commission's related proposed temporary exemption that would suspend operation of the proposed Regulation SHO bid test during a two-year pilot period, with respect to a category of actively traded issues designated by the Commission.

A. It Is Not Clear That Short Sale Restrictions Continue To Be Necessary to Protect Investors From Price Manipulation Through Short Selling.

As the Commission noted in its Proposal, the short sale rule was implemented in 1938 to restrict short selling in a declining market and thus prevent the potential manipulation of stock prices that might result from abusive short-selling activities. Since 1938, however, the markets have changed. In today's markets, investors have real-time access to information regarding issuers, their respective industries and many other factors that influence stock prices. The accessibility of this critical real-time information arguably makes it less likely that stock prices can be manipulated in declining markets through short selling, particularly in actively traded issues. Additionally, other safeguards either already exist in Commission proposals or could be added to

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provide additional protection against naked short selling.[1] For all of these reasons, the Exchange applauds the Commission's decision to consider whether or not the short sale restrictions should remain in place at all;[2] as noted below, however, the Exchange believes that the procedures proposed by the Commission in making this determination – and at least one detail of the proposed substantive rule – should be modified.

B. The Commission Should Evaluate the Need for the Short Sale Rule Prior to Industry Implementation of the Bid Test.

The Exchange acknowledges that the Commission may be hesitant to eliminate all short sale pricing restrictions without first measuring the impact of such action. The two-year pilot proposed in the Short Sale Rule Proposal,[3] following implementation of the proposed uniform bid test, seems aimed at achieving such a goal. The Exchange's comments regarding the proposed pilot exemption are two-fold.

First, the Exchange firmly believes that until the Commission determines whether some version of the short sale rule will be in place for the long term, the Commission should not impose a new uniform short sale rule that would require self-regulatory organizations (and, indeed, the entire securities industry) to incur the substantial costs of transitioning to a uniform bid test. As detailed below on page 5, the transition costs to the CHX enterprise alone likely will aggregate at least $500,000. The costs to our members could be exponentially higher than this, and the costs to the entire industry are likely to be of significant magnitude. The Exchange believes that such expenditure would be an unwarranted waste of vital technology and human resources if the Commission ultimately determines (after evaluating the short sale pilot exemption) that comprehensive short sale pricing regulation is not necessary (or not necessary for a large group of stocks). Conversely, if the Commission determines (after evaluating the short sale pilot exemption) that short sale pricing regulation is necessary, the securities industry could transition to a uniform bid test at that juncture.

Second, the Exchange believes that the criteria for selecting pilot exempt issues are insufficiently outlined in the Short Sale Rule Proposal. We recommend that the Commission seek public comment on a more specific proposal detailing the factors that the Commission would rely on in

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[1] For example, the Commission's own proposed locate and deliver requirements would curb any abuses resulting from naked short selling, which does pose risks to the marketplace. Further, if "circuit breaker" provisions were maintained by self-regulatory organizations, prohibiting trading (including short selling) in the case of precipitous market declines, the markets would be protected from potentially serious destabilization and large-scale decline in market valuation.

[2] The regulatory structure that governs the trading of single stock futures does not include any sort of short sale regulation. Because the inconsistent regulation of markets trading similar products can create opportunities for inappropriate regulatory arbitrage, the Exchange welcomes the Commission's decision to determine whether or not to continue imposing those restrictions on the equities markets.

[3] See 68 FR 62972 at 62983.

selecting pilot issues. The Exchange believes that the Commission would benefit from industry (and issuer) commentary regarding the criteria for selecting pilot issues.[4]

C. The Commission Should Incorporate A Specific Short Sale Exemption to Permit SRO Members to Honor Execution Guarantees.

The CHX notes that in the Short Sale Rule Proposal, the Commission appears to have expended considerable effort to analyze the continued utility of existing short sale exceptions and exemptions if Reg SHO is enacted.[5] While the CHX generally agrees with the Commission's conclusions in this regard, the CHX believes that the exemptions should be extended in two specific respects.

First, the CHX endorses the exemption in proposed Rule 201(d)(10), permitting execution of customer limit orders at the consolidated best bid to satisfy any order-handling obligations imposed by SEC or SRO rules.[6] The CHX believes, however, that this exemption should be extended to any customer market order that might similarly be due an execution. If a market order is resident in a CHX specialist's book, such order should be eligible for the same protections as a resting limit order. Moreover, in filling a resting market order, a specialist is acting in the same liquidity-providing role as when the specialist fills a resting limit order. Such activity does not raise the anti-manipulative concerns underlying the Short Sale Rule. The Short Sale Rule should not restrain a specialist unnecessarily from selling short in order to fill customer buy orders.[7]

Second, and of critical importance to the CHX, we believe that the Commission should provide a specific exemption to allow executions in accordance with execution guarantees that are provided by rules of particular market centers, where those executions occur at prices equal to, or even outside of, the current NBBO. This exemption would ensure that specialists and market makers are allowed to meet their rule-based obligations to customer orders while still protecting against any inappropriate market manipulation. For instance, the CHX has a rule, applicable to both listed and OTC securities, that guarantees execution of resting limit orders, at the limit

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[4] For instance, if the Commission exempts one issue within an industry, while the most comparable issue within the industry (*i.e.*, the principal competitor) would remain subject to short sale pricing regulation, short selling may migrate to the exempt issue, effectively skewing the data and negating the validity of the comparative analysis. The Exchange anticipates that the Commission will be receiving significant commentary from issuers outlining their competitive and capitalization concerns relating to the pilot exemption proposal, and therefore will not elaborate on this issue.

[5] *See* 68 FR 62972 at 62981, 62984-62990.

[6] *See* 68 FR 62972 at 62991.

[7] Short selling to fill a customer buy order is far different than a specialist short selling against the bid quote of another market or market makers. The former does not implicate the type of short selling concerns that led the Commission to remove the market maker exemption from NASD Rule 3350.

price, based on certain activity in another market center.[8] Execution of such orders at the limit price might sometimes be inconsistent with the proposed bid test, even though it is consistent with best execution requirements, as shown below.

Consider the following example relating to a listed issue traded on the CHX, under the proposed bid test:

* The NBBO is $50.00: $50.05 throughout the example. The minimum shortable price thus is $50.01.
* The CHX specialist is short 2000 shares. The specialist's book has buy limit orders @ $50.00 (500 shares) and $50.01 (1500 shares).
* NYSE executes a 2000 share order at $49.99, trading through the CHX specialist's book.
* In accordance with CHX Article XX, Rule 37(a)(3), the CHX specialist must execute the two orders in his book, at their limit prices.
* The order executed at $50.00 would violate the proposed bid test, because the minimum shortable price is $50.01, and the order would not be executed. Under the existing tick test of Rule 10a-1, however, the CHX specialist would be able to meet his guarantee to both orders without violating the short sale rule, because an execution at $50.00 would constitute an uptick from the last sale of $49.99.

Other situations, such as rapidly moving markets, could result in similar tension between order execution guarantees and the proposed bid test.[9] Because these executions outside of the proposed bid test are made pursuant to specific SRO rules requiring or permitting members to guarantee particular prices to their customers, they are not the types of executions that are designed to manipulate prices. For that reason, the CHX believes, an exemption to permit these executions, when consistent with principles of best execution, should be part of the revised short sale rule.[10]

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[8] *See* CHX Article XX, Rule 37(a)(3). For listed securities, this rule provides that resting CHX limit orders must be executed when the primary market trades at or through the limit price. For OTC securities, this rule generally allows CHX specialists to execute resting CHX limit orders when the bid/offer of a "designated market" locks or crosses the limit price. For both listed and OTC securities, CHX specialists must execute any manually executed market or marketable limit order at a price and size equal to the NBBO at the time the order was received or act as agent for the order in seeking an execution in another market center.

[9] For example, a CHX specialist who is short stock might be in the process of executing an order at a guaranteed price, but might not be able to complete the transaction before the bid moves away. Alternatively, a specialist might have momentarily overlooked an order due an execution at a specific price, and might be prevented from filling the order at that price because the NBBO has rapidly changed.

[10] The Exchange also supports changes to other provisions of the proposed rule. First, the Exchange believes that the current bid test might best be revised to permit short sales at a price *equal to* the national best bid, not just better than the best bid. It does not appear that this extension would greatly restrict the likely impact of the proposed short sale restriction; moreover, this change would enhance a CHX specialist's ability to execute incoming orders, or ITS

D. Significant Industry Resources Would Be Required to Implement the Proposed Uniform Bid Test and Related Provisions of Reg SHO.

The CHX believes that significant human and economic resources would be required to implement the proposed uniform bid test. Indeed, the CHX estimates that the costs of implementing the uniform bid test and related surveillance would aggregate at least $500,000 for the CHX and its floor member firms,[11] and that implementation would require at least 180 days from the time the final rule is published.[12] We understand that other commentators are questioning the efficiency and workability of the proposed uniform bid test. In light of these questions and the transition costs discussed in this letter, we recommend that the Commission not proceed with implementation of the uniform bid test at this time.

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commitments, even when the specialist is short, without allowing the manipulation of the market that the short sale rule is intended to address.

Additionally, the Exchange notes that the use of a consolidated bid test, while consistent among markets, highlights the many other inconsistencies among markets that thrive in the OTC marketplace. The Exchange anticipates that the Commission will soon be addressing questions of intermarket linkage and access and will welcome the opportunity to again share its views on those subjects.

[11] The financial estimate does not project the significant transition costs and timing considerations of CHX member firms that are order-sending firms. The CHX anticipates that numerous broker-dealers will supply the Commission with such estimates, including costs and timing considerations relating to customer communications initiatives.

[12] The financial estimate is based largely on the number of CHX and member firm employee work hours that would need to be dedicated to the project; the CHX does not foresee significant hardware or software expenditures associated with this project. As the Commission is aware, the CHX has a highly automated trading system that delivers orders to the floor electronically and provides for the automatic execution of eligible orders routed to the CHX. Embedded in the CHX trading system is a functionality that incorporates the current short sale tick test for listed securities (including applicable exemptions) and generates surveillance reports that are transmitted to the CHX Department of Market Regulation. The CHX's cost estimate contemplates incorporating the new bid test into the CHX trading system (for both listed and OTC securities), which would generate the necessary changes in corresponding surveillance reports. The cost estimate also contemplates necessary CHX communication with member firms, related training sessions and testing.

The CHX has also included in this estimate (a) CHX employee hours to develop a means of implementing the short sale test on an issue-by-issue basis (to permit pilot exemption of those issues identified by the Commission); (b) employee hours for related changes to other CHX systems and equipment, including the workstations used by CHX specialist firms; (c) CHX employee hours for review and potential upgrade of order marking functionalities; and (d) member firm employee hours for modifying related information systems technologies.

The CHX's estimate excludes ongoing maintenance costs, which could be material if the Commission frequently revises the list of issues subject to the pilot exemption. The estimate also excludes CHX opportunity costs, including the potential delay of projects and reports that are requested by the Commission from time to time. These costs are virtually impossible to quantify until the Commission releases its projected implementation timeline; only then will the CHX be able to evaluate the impact of this significant project on pending initiatives.

If the Commission determines not to defer implementation of the uniform bid test, then given the industry-wide ramifications of implementing Reg SHO, the CHX recommends that the Commission provide for a phased-in approach similar to the industry implementation of decimal pricing. Under this type of schedule, once the Commission publishes its final version of Reg SHO, the various SROs would be given a deadline by which to amend and/or adopt their corresponding rule provisions. During this process, SROs and broker-dealers could commence systems development work, and broker-dealers could begin communicating new requirements to their customers. Once the requisite systems have met industry-wide quality assurance standards, the transition to a uniform bid test then could be phased in gradually, first with a set of pilot securities (including a subset of issues that the Commission selected for the pilot exemption) and then ultimately for all issues. The Exchange further notes that it might benefit broker-dealers and their customers to first implement the uniform bid test for OTC issues, followed by listed issues.

E. Conclusion

The CHX commends the Commission on taking the first steps toward modernizing the Short Sale Rule. The CHX would caution the Commission, however, against mandating an industry-wide transition until it determines whether short sale pricing restrictions are necessary, particularly for active securities. The CHX would strongly encourage the Commission to further develop existing analyses, and perhaps to implement a two-year pilot using existing short sale regulations, rather than asking the securities industry to implement a comprehensive (and extremely costly) transition at this juncture.

In addition, the CHX recommends that the SEC expand the limited specialist exemptions discussed in this letter so that the new uniform bid test (if adopted) would not interfere with specialists' market making functions.

Please do not hesitate to contact me should you have any questions regarding the foregoing.

Very truly yours,

David A. Herron

cc: Andrew A. Davis
Ellen J. Neely, Esq.
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