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August 15, 2008

Ms. Florence E. Harmon  
Acting Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549-1090

Re: File No. S7-19-07  
Re-Proposed Amendments to Regulation SHO

Dear Ms. Harmon:

On behalf of the Chicago Board Options Exchange, Incorporated, I want to thank you for providing the opportunity to offer further comment on the Securities and Exchange Commission's ("SEC" or "Commission") re-proposal to eliminate or narrow the options market-maker ("OMM") hedge exception to the Regulation SHO close-out requirement. We appreciate the time and consideration that the SEC has put into evaluating the proposed changes to the exception.

We understand that the Commission's reason for considering the re-proposal is to help reduce persistent, large fail positions in threshold securities, which the SEC has found may be used to facilitate some manipulative strategies. While we appreciate the end goal of thwarting manipulation, OMM hedging is risk neutral - not "naked" - and is not the type of activity that would fall into this category. For the reasons we more fully describe in our letters of September 17, 2007 and October 11, 2006, we are concerned the re-proposal would unduly encumber the OMMs' ability to legitimately provide liquidity and serve as a risk-reduction resource for investors in the underlying securities.

As described below, based on the data available, we do not believe there is evidence of a significant problem with extended fails to deliver or, if such a problem exists, evidence that it is attributable to the OMM hedge exception. Thus, eliminating or narrowing the OMM hedge exception would not further the objective the Commission is hoping to achieve. The perceived benefits of modifying the exception, on the other hand, would not outweigh the associated costs and burdens placed on OMMs and options markets they support. Additionally, the contours of the OMM hedge exception - which serves an important function in the maintenance of liquid, fair and orderly markets - are narrowly tailored and should be maintained. In putting the re-proposal into context, the Commission should consider the following:

- The data made available by the SEC overwhelmingly demonstrates that the instances of extended fails to deliver are minimal. The vast majority of trades settle on time (*i.e.*, +99% settle within T+3). The average daily number of securities on the threshold list - an average of 354 per day for the latest period reviewed - remains extremely low at well less than 1% of all equities securities. Of those, the number associated with optionable securities is even lower - an average of 190 per day for the latest period reviewed. The majority of "persistent" threshold securities (defined by the SEC staff as a security that has remained on

the threshold list for more than 17 consecutive settlement days and continues to have fails of 10,000 shares or more) are exchange-traded funds (“ETFs”) and similar products that do not raise the same abusive short selling concerns. For example, the data shows that of 350 unique securities that were persistent threshold securities during the period of May 1, 2007 through January 31, 2008, approximately 219 or 62.6% were ETFs or similar products. In addition, the overwhelming number of securities that were on the threshold list “graduated from the list,” while a smaller number has persisted since Regulation SHO’s implementation. All-in-all, the overall incidence of substantial, persistent fails in threshold securities that are individual stocks underlying exchange-traded options remains very low.

- For the threshold securities, data has been made available analyzing the periods pre- and post-elimination of the “grandfather” exception, broken down between threshold securities with listed options and those without. The preliminary conclusion of the SEC staff appears to be that the elimination of the grandfather exception did not lead to any meaningful reduction in fails for optionable securities, but that there is some evidence its elimination led to a reduction in fails for non-optionable series. We do not believe this data is conclusive evidence that the OMM hedge exception disproportionately contributed to fails or that it should be eliminated or narrowed.
- Simply because there are fails attributable to the OMM hedge exception should not be a reason to eliminate the exception. Because the exception exists, one would necessarily expect to see fails associated with OMM hedges. The data demonstrates that these exceptions are not excessive. They are associated with legitimate hedging activity and must meet the narrowly tailored bounds prescribed in the rule. Additionally, though eligible, OMMs do not always assert the exception and they oftentimes close-out when not required. We believe that the number of shares closed out by OMMs dwarfs the number of exceptions they claim.
- We recognize that the SEC’s proposal to eliminate the OMM hedge exemption is predicated in part on the belief that persons who want to engage in naked short selling in stock with extended fails may attempt to do so through buying put options and thereby transfer the selling pressure to OMMs, who hedge by shorting the underlying stock. We have not seen any data to suggest that this occurs more than a de minimis amount of time. Moreover, to the extent that this activity occurs, we have not seen data that suggests that such short sellers are attempting to manipulate a threshold security through buying puts in order to create selling pressure through OMMs’ hedging activity. In other words, there is nothing in the data to suggest that there has been manipulative activity predicated on the effect arising from the exceptions.

We recognize that the Commission is extremely interested in removing the causes of extended fails in threshold securities. While we understand the SEC’s motivation, we do not think that the objective should be solely to eliminate all extended fails if there would be collateral harm in achieving this goal. Specifically, there should not be a forced close out of OMM hedging-related fails irrespective of the consequences to the market. It is impracticable and an overly broad means to address any potential abuses in a manner that could unnecessarily restrict legitimate OMM hedging activity and disrupt the efficient functioning of the markets and CNS.

If the SEC’s desire to eliminate extended fails outweighs the need for the existing OMM hedging exception, we would prefer the SEC narrow the exception in the manner proposed as

Alternative 1 (with some modifications) because it would be easier to administer than Alternative 2. As we indicated in our September 17, 2007 comment letter, Alternative 1 would provide that, for fails resulting from a hedge or an adjustment to a hedge of options series created before the threshold date, an OMM must close out the entire fail position, including any adjustments to that position, within 35 consecutive settlement days of the threshold date. We would propose that the number of days be increased from 35 to 42 consecutive settlement days. This change would assure that an OMM has at least two options expirations before a fail position must be closed out. Ideally an OMM should be able to maintain a hedge. But if a close out must occur, allowing for this added time may help reduce the risk and potential harms to the markets by enabling an OMM to more efficiently and effectively close out an extended fail.<sup>1</sup> Finally, we also suggest that options exchanges be allowed to oversee and grant relief by giving OMMs additional time to reduce fail positions where necessary to maintain a fair and orderly market.<sup>2</sup>

We appreciate the thoughtful process the Commission has undertaken in continuing to evaluate the OMM hedge exception. We trust that in whatever manner you proceed it will strike an appropriate balance that preserves the fair and efficient functioning of liquid markets. Please do not hesitate to contact me, Jim Adams at 312-786-7718, or Jennifer Lamie at 312-786-7576, with any questions you may have.

Sincerely,

  
Edward J. Joyce  
CBOE President & Chief Operating Officer

cc. The Honorable Christopher Cox, Chairman  
The Honorable Luis A. Aguilar, Commissioner  
The Honorable Kathleen Casey, Commissioner  
The Honorable Troy A. Paredes, Commissioner  
The Honorable Elisse B. Walter, Commissioner  
Dr. Erik Sirri, Director, Division of Trading and Markets  
Robert L.D. Colby, Deputy Director, Division of Trading and Markets  
Elizabeth King, Associate Director, Division of Trading and Markets  
James A. Brigagliano, Associate Director, Division of Trading and Markets  
Josephine J. Tao, Assistant Director, Division of Trading and Markets  
Victoria L. Crane, Branch Chief, Division of Trading and Markets

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<sup>1</sup> We also suggest that the Commission consider increasing the number of days from 13 to 42 consecutive settlement days for post-threshold hedging activity of OMMs, thus creating a standard 42-day close out period for all OMM hedging activity. While this may introduce a modest expansion of the existing exception in some respects, it would be offset by the proposed narrowing of the exception in other respects. The resulting structure of the OMM hedge exception would strike a reasonable and appropriate balance because it would (i) immensely simplify the administrative costs and burdens attendant to tracking the exception placed on OMMs and their clearing firms, and (ii) provide a more reasonable period of time to allow the OMM to re-adjust its hedge or close out the fail at a price that might minimize economic harm to the OMM and disruption to the options market, while (iii) still furthering the Commission's desired goal of assuring that there will be a close out by a certain date.

<sup>2</sup> Our request to have the ability to grant relief is based on an understanding that the equity exchanges are already permitted to grant relief to stock specialists in certain circumstances.