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October 11, 2006

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090



Re: File No. S7-12-06
Proposed Amendments to Regulation SHO

Dear Ms. Morris:

The Securities and Exchange Commission ("Commission") has proposed changes to Regulation SHO that would eliminate the "grandfather" provision and narrow the options market maker hedge exception to the threshold security close-out requirements under Rule 203, as well as amend the exception for unwinding index arbitrage positions under Rule 200(e).[1] The Chicago Board Options Exchange, Inc. ("CBOE") is submitting this letter to express our views concerning the Proposal, particularly to those aspects that could disrupt the options markets and adversely impact liquidity and the investing public.

According to the Commission's analysis, Rule 203 appears to be operating as intended. Given this success, we do not believe the proposed changes are needed at this time. With respect to the options market maker hedge exception in particular, we believe that the existing hedge exception is already very narrowly tailored. Surprisingly, the Proposal seeks to further narrow the exception by no longer permitting options market makers to retain a residual short stock position once related pre-threshold options positions are liquidated or expire, even if the retention of the residual short stock positions would be used to hedge options positions taken on in the course of performing bona-fide options market maker functions. Not only would this restrict legitimate activity, it would actually serve to disrupt the markets. Specifically, the resulting exception would not provide sufficient flexibility to permit efficient hedging by options market makers, will unnecessarily increase risk and costs to hedge, and will adversely impact liquidity and result in higher costs to public customers.

Below we summarize our views and supporting arguments for maintaining the existing options market maker exception, which is critically needed to ensure the ongoing effectiveness of the listed options markets. We also express our concerns with the proposed elimination of the grandfather provision and our support for the proposed amendments related to unwinding index arbitrage positions.[2]

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[1] See Securities Exchange Act Release No. 54143 (July 14, 2006), 71 FR 41710 (July 21, 2006) (the "Proposal").

[2] Additionally, we support the comments offered by the Securities Industry Association ("SIA") expressing concerns about: (i) the question posed on potentially requiring clearing firm participants to identify and take action against specific customer accounts that are responsible for fails; (ii) the question posed on whether broker-dealers, in order to comply with the Regulation

## I. Options Market Maker Hedge Exception

Under the current provisions of Rule 203, as with other market participants, an options market maker is generally subject to a close-out for fails to deliver that remain with his clearing firm for thirteen consecutive settlement days and, until the fail is closed out, is required to pre-borrow. The existing exception to these requirements relates only to those short positions that hedge, or adjust a hedge on, options positions created pre-threshold. Any other short sales of a threshold security by options market makers remain subject to the close-out and pre-borrow requirements.

While the Proposal would not go so far as to completely eliminate the exception, the changes would significantly affect options market makers' ability to hedge and provide liquidity to public customers. First, under the existing exception, as pre-threshold options positions are liquidated or expire, an options market maker can maintain his residual short stock position. Under the proposed revisions, the residual short stock position would become subject to close-out upon liquidation or expiration of the overlying options position(s), and thus could no longer be used to offset continued trading in the overlying options. This aspect of the Proposal would narrow the life of the exception and subject options market makers to close-out and pre-borrow scenarios more often, exposing them to greater risks and costs when faced with continued options trading, reversal scenarios and buy-ins, overnight risks and the like. Second, the proposed revisions would also impose a limitation that would prevent the use of a residual position to offset other pre-threshold options positions. This aspect of the Proposal would appear to narrow the scope of the exception and is a concept that we believe fails to adequately account for the complexity of options market maker risk management. Both aspects of the Proposal are considered below.

### A. *Options market makers must retain short stock positions to hedge risk.*

In evaluating whether to narrow the life of the options market maker hedge exception, the Commission asks why an options market maker needs to maintain a short position once the pre-existing options position(s) are liquidated or expire. In response, we believe the reasons are the same as the rationale underlying the Commission's approval of the original exception. Foremost among those reasons are the following:

- ***The cost of the inability to hedge efficiently with a short sale will be borne by investors***. When options market makers are unable to hedge with a short stock position, the risk and costs to the market maker are increased. To compensate for this risk, options market makers may widen their markets and/or reduce their available size, thereby lowering the quality of options markets available for public customers. Thus, the ability to sell stock short through use of the options market maker hedge exception increases the depth and liquidity in the options markets, reduces risk to options market makers and fosters better executions for investors without engaging in activity that the short sale regulation was designed to prevent.

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SHO "locate" requirement, may not rely on feeds received from lenders who do not decrement the stock they have available to lend; and (iii) the question posed on whether to require firms to annotate, with respect to "long" sales received from customers, the present location of the securities being sold and whether they are in good deliverable form. We also second the SIA's views supporting: (i) the proposal to exempt from the Regulation SHO close-out requirement fails in threshold securities that result from sales of "owned" securities; (ii) the proposal to exempt exchange-traded funds ("ETFs") and similar structured products from the definition of "threshold security;" and (iii) the proposal to allow clearing firms increased flexibility to clean-up fails in threshold securities by borrowing securities, rather than requiring securities to be bought-in. Letter from Ira D. Hammerman, Senior Vice President and General Counsel, SIA, to Nancy M. Morris, Secretary, Commission (September 19, 2006).

- ***Options market making obligations are the basis for the exception.*** The rules of the Commission and the options exchanges impose many affirmative obligations on options market makers. The most significant of these is the firm quote requirement. In addition, 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, it is crucial for options market makers to be able to execute short sales to hedge the risk of providing such functions without being unduly constrained in order to facilitate trading and to help ensure a favorable execution price for the investing public.[3]

- ***To qualify for the exception, options market makers' stock activity is limited to hedging.*** The existing exception is already very narrowly tailored in that it is limited to short sales effected to hedge pre-threshold options positions and the resulting residual short stock position that can continue to be carried.[4] In proposing to further limit the exception, the Commission appears to question whether an options market maker that continues to carry a short position after pre-existing options positions are liquidated or expire is engaged in providing liquidity to customers or rather is engaged in speculative trading activity characteristic of manipulative short selling. To answer the question, the extended maintenance of a short stock position pursuant to the exception is not indicative of a speculative trading strategy, but is directly related, and absolutely necessary, to providing liquidity for customers in the overlying options. 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 losses. In addition, aside from Regulation SHO, there are regulatory deterrents for misusing the exception for speculative purposes.

- ***Options market makers must be able to sell stock short to hedge.*** 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. Options market makers typically have positions in many, if not all, of the options series in an appointed class. They will incur long exposure when they have to buy calls and/or sell puts. A market maker may liquidate or hedge his net long side options position with other offsetting options, but this may be difficult because other market makers are also trying to manage long side exposure and/or public order flow on the sell side. The only possible alternative action is hedging in the stock. Because options market makers hedge on a class basis, they typically will put on a stock hedge that represents a delta. As those positions are rolled to forward months, the options market maker may need to maintain the hedge. The short stock needs to be maintained not

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[3] Indeed, for these reasons it would arguably be reasonable and appropriate to apply a blanket exception to exempt all bona-fide options market maker hedge activity, whether for options positions created prior to or after an underlying security becomes a threshold security.

[4] The exception already has very restrictive limitations. For example, if in the course of fulfilling his market making obligations, an options market maker increases his options positions to accommodate incoming orders, the market maker still cannot sell short the underlying threshold security to hedge the options positions that were created after the threshold date. As another example, if an options market maker cannot maintain and/or establish a short hedging position in an underlying threshold security due to the constraints of the close-out and pre-borrow requirements, the options market maker cannot sell the underlying security short to accommodate incoming options orders (even if such orders were closing transactions). Unfortunately, there is currently no authority for a self-regulatory organization ("SRO") to provide exemptive relief to options market makers in such scenarios, even if it is in the interest of maintaining a fair and orderly market. Narrowing the exception only increases the potential for these problems. We fear the proposed changes will not provide options market makers with sufficient flexibility, making it even more difficult for them to fulfill their responsibilities and hedge their options positions quickly and efficiently.

because it hedges a particular series, but because it maintains the delta of the overall position. If a series is liquidated and not replaced, an options market maker will reduce the short stock positions because economics dictate that he should. However, if an options series is replaced with more forward positions, there is no reason for the options market maker to reduce the short stock hedge.

- ***Options market makers have no incentive to force the price of a stock lower.*** Options market makers assume stock positions to hedge the option positions in which they make markets in an effort to remain market neutral. Because the short selling activity is limited to hedging, any gains on a short stock position would be offset by exposure in the options, leaving an options market maker with no motive to engage in the type of speculative short selling that Regulation SHO is intended to pre-empt. Thus, narrowing the exception would do nothing to address abusive naked short selling.

- ***Options market makers should not be impeded or penalized from selling stock short to hedge legitimate options market maker risk exposure, even when there exists an inability to deliver the stock.*** Normally, options market makers are able to hedge their overall risk exposure through any number of combinations of options positions and stock. The existing exception to the close-out and pre-borrow requirements assists options market makers in their efforts to achieve a market neutral position in threshold securities without bearing the potential delays and attendant costs. Further, the existing exception enables options market makers to make tight, liquid markets in the overlying options. The need for the exception is even more important for making markets in options overlying hard-to-borrow securities that become subject to the close-out and pre-borrow requirements. If an options market maker is unable to adequately hedge, the market maker will most certainly increase the width of his spread, decrease the size of his quotes drastically, or be exposed to unacceptable levels of risk.[5]

CBOE believes that the existing hedge exception from the close-out requirements for options market makers selling stock short to hedge the risk exposure of options positions obtained in the course of performing bona fide market making functions is vital to the operation of the options markets. The exception is for the sole purpose of managing the risk exposure of bona-fide options market making activity that is essential to the operation of the options markets and, by its current terms, severely limits the amount that an options market maker can be short. It does not impose any undue burden on the markets for securities underlying listed options or on the stock specialists or market makers, nor has it raised any regulatory concerns. Indeed, options market maker hedging activity does not involve the type of abusive market behavior that short sale regulation is intended to address. Options market makers generally do not profit from short sales of stock because they can sell stock short only as a hedge of their options activity.

If the Commission limits the duration of the exception to the life of the original options position being hedged, it will place options market makers in a very risky position. At least under today's scenario, a residual short security position can be used to help an options market maker manage his risk when he continues to accommodate the rolling of options positions by customers or assumes options positions overlying a threshold security. If the proposed rule is adopted, the short stock position would have to be closed out and could not be used to offset other options positions, whether existing in the

[5] Requiring a close-out or pre-borrow, in effect, shuts down short selling activity, regardless of its legitimacy. We do not agree with this requirement because of the resultant impacts it will have on a market maker's ability to fulfill his obligations, the market for the overlying options, and the stress placed on the clearing system in general. The elimination of the ability to retain at least the pre-threshold position only serves to worsen the problem.

market maker's book at the time or thereafter acquired as the result of continued put selling and call buying. Options market makers could be placed at great risk and subject to increasing costs when faced with continued put buying and/or call selling interest in a threshold security with a long period of extended fails to deliver. It is much easier and less risky for the options market maker to continue to use a residual short stock position as a hedge for his options positions. Otherwise, the increased risk will be represented in the price paid by public customers.

***B. Options market makers hedge their book, not a position.***

We strongly object to the Commission's proposal to modify the text of Rule 203(b)(3)(ii) to refer to "an options position" rather than "options positions" to make clear that options market makers would not be permitted to move their hedge on an original options position to another pre-existing options position to avoid the proposed close-out requirements. (See note 28 of the Proposal.) This aspect of the proposal appears to be rooted in the notion that options market makers hedge on a strategy-based or single-position-by-single-position basis, and not on a portfolio basis. However, market makers generally do not tie a hedge to a particular strategy or trade. Options market maker risk management strategy is much more complicated. They hedge their overall book of positions and, as a result cannot dissect each option position in the manner the Commission suggests. Instead, like portfolio margin, risk-based haircuts and delta-based position limits, Regulation SHO should continue to support a risk-based view to bona fide options market maker hedging.

When a security goes on the threshold list, an options market maker has a set, identifiable number of long call and short put options positions in the overlying options series for which he can hedge with short stock. These options positions might be hedged with other options positions and/or with stock and adjusted overtime. 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 Since it is a finite set of options positions that can form the basis determining the maximum amount eligible for the short stock hedge (*i.e.,* only those options positions that existed pre-threshold), it is not clear to us what end the textual change is designed to achieve. The overall result may be an unnecessarily harsh restriction on an already extremely narrow exception that is essential to the options market makers' ability to effectively function and fulfill their market making obligations.

For these reasons, we respectfully request that the Commission reconsider its proposal and continue to maintain the existing exception exempting options market makers from the close-out and pre-borrow requirements for threshold securities when hedging legitimate market making activity. If anything, we believe the Commission should maintain the status quo, but clarify that a residual short stock position for which the overlying pre-threshold options have liquidated or expired must be closed-out after thirteen consecutive settlement days in accordance Rule 203 *unless* it is used to offset other options positions within a set time period after the liquidation or expiration of the pre-threshold options positions. As an options market maker's option positions are liquidated or expire, the market maker will either extinguish the stock hedge or use the hedge for other options positions. This will happen very quickly, because an options market maker will not want to maintain an unhedged short stock position for any length of time. We also suggest that the options exchanges be allowed to grant relief to give market makers time to roll or reduce fail to deliver positions in the interest of maintaining fair and orderly markets.

Any further narrowing of the exception would appear to do little, if anything to prevent manipulative short selling activity. On the other side of the scale, the effect would be to further restrict legitimate trading activity necessary in the course of bona fide options market making. Moreover, the Proposal would do much more than impact options market makers. It would unnecessarily impact liquidity in the marketplace, and the overall efficiency and effectiveness of the price discovery mechanism for stocks and options. It would impose increased costs and compliance burdens on market participants, particularly the options market maker and their clearing firms, which translate to increased costs to public customers. It would also create buy-in pressures when multiple participants run to the market to close their positions, artificially impacting the stock price. Unfortunately, these increased costs appear to be greatly disproportionate to the potential benefit, and will not necessarily translate into better regulation of abusive short selling activity.

We also note that short stock positions of options market makers as a percentage of the total number of shares outstanding or float is believed to be small and has not reached a level of short sales that could justify concerns about manipulation. What is more, only a very limited number of threshold securities currently have overlying options (84 is the last count). Of those, several are very actively traded. Many are also ETFs, which we believe should not be subject to the threshold security requirements.[6] In addition, the Proposal provides no data to show that options market makers are responsible for the few substantial, persistent fails to deliver that exist or that the sales are not the result of bona-fide hedging activity. To the extent there are shorts attributable to market makers, they are clearly not abusive or unwarranted. We therefore question whether the Commission needs to take the drastic measure proposed for a small number of threshold securities, particularly given that the amendment could place options market makers at risk, increase costs to investors and potentially impose other negative consequences.

## II. Grandfather Provision

We do not support the proposed elimination of the grandfather provision. The pre-existing positions themselves are not indicative of abusive or manipulative short selling activity. As a result, elimination of the grandfather provision would not target abusive short selling, and modifying the exception would therefore not further the objectives of Regulation SHO. Conversely, its elimination could adversely impact stock liquidity and borrowing, unnecessarily increasing costs to investors.[7] Additionally, requiring a close-out of grandfathered positions within thirteen consecutive settlement days is not sufficient time to liquidate, particularly in hard-to-borrow securities, where the likely consequence may be a short squeeze in the threshold security. This would also impact trading in the options markets.

When considering the proposed revisions, we believe it is important to appreciate the broader context in which the exceptions to the threshold securities requirements exist. Specifically, short selling in and of itself is not manipulative. In fact, short selling plays an important and vital role in the effective operation of the capital markets by providing liquidity and pricing efficiency. The best markets operate freely and efficiently, with actual selling and buying interest reflected in the price of a security. And, while the use of mechanical barriers may be useful in combating manipulative short selling behavior, they necessarily also raise concerns about impeding legitimate trading activity. With this in mind, the safeguards imposed under Regulation SHO should be designed to target and pre-empt abusive naked short

[6] See note 2 supra.

[7] The market risks, increased costs and compliance resources associated with the elimination of the grandfather provision may translate into fewer market makers being willing and able to make markets in threshold securities and the overlying options. This would increase costs and impact liquidity in both the stock and options markets.

selling while, at the same time, to not unnecessarily restrict legitimate activity, the price discovery mechanism, and the overall efficient operation of the marketplace.

It is against this backdrop that Rule 203's threshold security requirements were adopted. When it formulated the existing threshold requirements, we believe the Commission struck a reasonable balance. On the one hand, because a persistent fail in a threshold security is thought to be characteristic of potential manipulative short selling, threshold securities are subject to strict close-out requirements for existing short positions and pre-borrow requirements for subsequent short sales. On the other hand, the Commission acknowledged the need to not impede legitimate activity by adopting the grandfather and options market maker hedge exceptions. Preliminary data examined by the Commission validates this approach. According to the Commission, the data reveals that Regulation SHO appears to be significantly reducing fails to deliver without disruption to the market. The Commission's review indicates that the vast majority of trades settle on time (*i.e.,* 99% settle within T+3) and, of the very small percentage with fails to deliver, the vast majority of the fails are closed out within five days after T+3. The Commission also analyzed all stocks with aggregate fails to deliver of 10,000 shares or more utilizing various measures and found that all of these measures showed declines in fails to deliver.[8] Further, the Commission observed that the average daily number of securities on the threshold list is approximately 298 or 0.38% of all equities securities. In addition, the overwhelming number of securities that were on the threshold list "graduated" from the list, while only six securities persisted throughout the pre- and post-Regulation SHO period examined. For those six, fails to deliver declined by 68.6%. Thus, the overall incidence of substantial, persistent fails in threshold securities is extremely isolated. Additionally, there is nothing in the data to suggest that there has been manipulative short selling as a result of the exceptions, any abuse of the exceptions or an inability of the regulatory process to detect and prosecute either.

Despite the positive review and the lack of any apparent abuses of either exception, it appears that the proposed amendments are designed to close what may be viewed by some as "loopholes" in Regulation SHO that perpetuate extended fails to deliver thought to be characteristic of abusive naked short selling. However, that is simply not the case. The exceptions are intended to address certain activities that, by their nature, are not indicative of manipulative short selling: For example, the grandfathered positions are representative of pre-threshold interest, acquired at a time when there was no close-out requirement. Requiring those positions to be closed (*i.e.,* bought-in) would do nothing to address manipulative activity on the short sell side.[9] Similarly, as discussed above, because an options market maker's short stock must hedge offsetting options positions, the options market maker short stock positions result in a neutral market posture and thus are not undertaken to manipulate the price of the underlying stock.

Given the data and that the excepted positions themselves are not indicative of manipulative behavior, we question the need for the proposed changes. We do appreciate the Commission's efforts to fine-tune Regulation SHO in terms of further targeting manipulative short selling behavior and accommodating the legitimate needs of the marketplace, both of which serve to protect public customers and market integrity. But, on balance, we seriously doubt that the changes contemplated in the Proposal would thwart manipulative short selling as much as they would restrict legitimate activity or, worse yet,

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[8] Proposal at 41710 – 41712. See also Memorandum from the Commission's Office of Economic Analysis regarding Fails to Deliver Pre- and Post-Regulation SHO (August 21, 2006).

[9] Though we believe the exceptions should remain unchanged, we appreciate the Commission's request for comment on whether borrowing, rather than purchasing, securities to close-out a position would be more effective in reducing fails to deliver. See Proposal at 41714. We believe borrowing would present less of a chance of adversely impacting the market as a buy-in may.

disrupt trading in any threshold security or overlying option. We also appreciate what may be the Commission's secondary objective of simply limiting substantial, persistent fails to deliver. However, we caution that the Commission should not move toward forced closed-outs irrespective of the consequences. The changes being proposed are unnecessary and much too broad to target isolated instances of extended fails, particularly when considering that the number of securities with extended fails has been reduced to a minimum level, there has been no disruption to the marketplace, and there are other tools at regulators' disposal that would not adversely impact the markets.[10] Requiring a close-out of the currently excepted positions, particularly through a buy-in, is a costly, impractical and overly broad means to address any potential abuses in only a handful of securities that would needlessly constrain legitimate activity.[11] More importantly, it would impose requirements that would potentially disrupt the stock and options markets. We do not think it is worth the added costs imposed on public customers and the markets or the increased risk to options market makers. Because requiring a close-out of the excepted positions would not only get away from the primary objective of Regulation SHO - preventing manipulative short selling while not unnecessarily restricting legitimate activity – but would actually increase the potential for disruption to the marketplace, we cannot support the proposed changes to Rule 203.

For these reasons, the elimination of the grandfather provision would seem to be an overly broad means to address the narrow issue of substantial, persistent fails to deliver that may occur in only a small subset of threshold securities. As a starting point, the existing close-out provisions should continue to be the primary means to resolve substantial, persistent fails. If the Commission believes that something beyond that is necessary, perhaps the Commission should consider narrowing the focus of its rulemaking to address only persistent threshold securities rather than all threshold securities. In this regard, perhaps grandfathered positions could become subject to a close-out requirement if a threshold security has a substantial number of fails and consistently remains on the threshold list for an extended period of time. In any event, should the Commission move toward narrowing the grandfather provision in this manner, we request that the Commission provide an exception for options market makers.

## III. Rule 200(e) Exception for Unwinding Index Arbitrage Positions

The Commission is also seeking to amend Rule 200(e)(3) of Regulation SHO to reference the New York Composite Index (NYA) instead of the Dow Jones Industrial Average (DJIA), for purposes of the market decline limitation. CBOE has no objection to the use of the NYA but believes that the timeframe of this restriction should be consistent with NYSE Rule 80A, which terminates the restriction at the end of the trading day. (Regulation SHO terminates the restriction at the end of the succeeding trading day.)

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[10] There are various other tools at regulators' disposal to identify and target manipulative short selling and/or extended fails. For example, the abusive naked short selling activity that Regulation SHO is designed to pre-empt is also subject to Commission and SROs' rules on just and equitable principles of trade, manipulative, deceptive or other fraudulent devices, net capital requirements and customer protection rules. Regulators also have access to fail to deliver information and can inquire to confirm compliance with the rule's restrictions and exceptions pertaining to threshold securities.

[11] Requiring a close-out and/or a pre-borrow decreases liquidity in the underlying market, imposes large borrowing costs and execution delay, and impacts options trading as well as stock lending, clearance and settlement. It leads to a strain or ultimately no options trading in hard-to-borrow securities. Assessing the probability that a security will become threshold and subject to heightened close-out and borrowing requirements also impacts underlying trading in those securities as well.

CBOE thanks the Commission for this opportunity to present our views concerning the proposed rulemaking. Without evidence that the existing regulatory and surveillance systems are fundamentally flawed or that the exceptions are being abused, we see no reason for such radical changes. We strongly urge the Commission to consider the adverse effects of imposing these changes on the options marketplace. We also support and agree to participate in further discussions on this matter, particularly as it relates to the impact on options markets. Should you have any questions concerning CBOE's comments, please contact Jim Adams at 312-786-7718 or Jennifer Lamie at 312-786-7576.

Sincerely,

Edward J. Joyce

Edward J. Joyce
CBOE President & Chief Operating Officer

cc. The Honorable Christopher Cox, Chairman
The Honorable Paul Atkins, Commissioner
The Honorable Roel Campos, Commissioner
The Honorable Annette Nazareth, Commissioner
The Honorable Kathleen Casey, Commissioner
Dr. Erik Sirri, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation
Elizabeth King, Associate Director, Division of Market Regulation
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