



Edward J. Joyce
President and
Chief Operating Officer

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

September 17, 2007

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

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

Dear Ms. Morris:

The Chicago Board Options Exchange, Incorporated ("CBOE") appreciates the opportunity to respond to the Securities and Exchange Commission's ("Commission") proposal to modify Regulation SHO.¹ The Commission is considering whether to eliminate the options market maker ("OMM") hedge exception to the Regulation SHO threshold security close out requirements, along with two alternatives for modifying the current exception. We believe the proposed elimination or narrowing of the OMM hedge exception would unreasonably expose OMMs to increased risk and would adversely impact liquidity, investors and the marketplace. As a result, our strong preference is to leave the current exception as is. If the Commission is determined to make a change, we believe the alternative approach outlined below would prevent some of the risk and liquidity impairment that is anticipated to occur. Lastly, the Commission is also proposing to require broker-dealers to document the present location of securities being sold "long," which we believe would create an unnecessary administrative burden, potential delays and attendant costs.

Options Market Maker Hedge Exception

Regulation SHO, adopted by the Commission in August 2004, included several changes to the regulation of short sales. One of the changes imposed additional requirements on broker-dealers for "threshold securities"² that were intended to preempt potentially abusive naked short selling activity. Specifically, when there is a failure to deliver on a short sale of a threshold security and the fail persists for 13 settlement days, a clearing firm must close out the short position. Until the fail to deliver has been closed out, new short sales in the threshold security

¹ Securities Exchange Act Release No. 56213 (August 7, 2007), 72 FR 45558 (August 14, 2007)(the "re-proposal").

² Under Rule 203, if for five consecutive days a stock has aggregate fails to deliver at a clearing agency of 10,000 shares or more representing at least 0.5% of an issuer's shares outstanding, the stock will be considered a "threshold security."

cannot be effected unless the security has been pre-borrowed. Currently, there are two exceptions to the close out requirements:

- The grandfather exception, which provides that a fail to deliver position established prior to the security becoming a threshold security does not need to be closed out. This exception currently applies to all market participants, including OMMs. However, the Commission recently amended Regulation SHO to eliminate this exception effective October 15, 2007.³
- The OMM hedge exception, which provides that any fail to deliver position in a threshold security that results from a short sale effected by an OMM to establish or maintain a hedge on options positions created before the underlying security became a threshold security does not have to be closed out.

In August, the SEC issued the re-proposal⁴ to seek comment on whether the OMM hedge exception should be eliminated, as well as two proposed alternatives that would significantly narrow the exception. For the same reasons we have previously stated,⁵ we strongly oppose the elimination or narrowing of the OMM hedge exception because it would make it all the more difficult for OMMs to effectively hedge, which would adversely impact the options markets as well as the underlying stock markets. Moreover, the changes contemplated in the instant re-proposal would go well beyond what was previously considered and would place OMMs at even greater risk.

³ Securities Exchange Act Release No. 56212 (August 7, 2007), 72 FR 45544 (August 14, 2007).

⁴ Previously, in July 2006, the Commission issued a proposed rulemaking that would have narrowed the OMM hedge exception in two respects. First, under the existing exception, an OMM can maintain a residual fail to deliver position that had been used to hedge options positions created before the threshold date even if those pre-threshold options positions are later liquidated or expire. Under the proposed revisions, the residual fail to deliver position would have become subject to close out 13 settlement days after liquidation or expiration of the overlying options position(s). Second, the proposal would have amended Rule 203(b)(3)(ii) to refer to "an option position" rather than "options positions" so as not to permit a hedge on an original options position to be moved to another pre-existing options position to avoid application of the close out requirements. See Securities Exchange Act Release No. 54154, 71 FR 41710 (July 21, 2006)(the "2006 proposal").

⁵ In commenting on the 2006 proposal to narrow the OMM hedge exception, we noted that the current OMM hedge exception is a necessary tool to facilitate OMMs in performing their options market making obligations and that the exception is already narrowly tailored because it only applies to short stock fails created to hedge or adjust a hedge on options positions created by an OMM *before* (and not *after*) a security issue goes on the threshold list. Because the exception is narrowly tailored, limited to OMM hedging activity (which requires the selling of stock short to maintain a risk neutral – not "naked" – position) and OMMs relying on the hedge exception have no incentive to force the price of a threshold stock lower (with a risk neutral stock and option position, any decrease in the stock would be offset by a corresponding increase in the option), we indicated that OMM hedge positions are not indicative of abusive naked short selling activity, that OMMs should not be further impeded in their ability to meet legitimate market-making obligations, and that any costs associated with further narrowing the exception would ultimately be borne by investors. See letter from Edward J. Joyce, President and Chief Operating Officer, CBOE, to Nancy M. Morris, Secretary, Commission (October 11, 2006).

The ability to hedge with stock is integral to an OMM's ability to perform his bona fide options market making responsibilities and manage risk.⁶ At least under the current structure, the impact of the current close out requirements on an OMM's ability to hedge are directed at *post*-threshold date activity and an OMM can prospectively attempt to factor the added hedging risks and costs into his post-threshold options trading and stock hedging activity. However, with the proposed changes, OMMs would now be penalized for *pre*-threshold date activity. Being able to anticipate and account for the added pre-threshold risk may be extremely difficult and costly. This most certainly would impact OMMs' willingness to make markets in options overlying threshold securities or securities that potentially could become threshold securities. In other words, whereas our concerns with the restrictions of the present exception are primarily limited to increased OMM risk and decreased market liquidity while a securities remains on the threshold list, the same concerns would now also apply to the period before a security goes on the list --- which could be anytime for an unknown number of securities! This is a real concern for any options series that may expire more than 13 settlement days out and especially so in longer term options, which may expire up to 3 years (and in some cases longer) from their original listing.

If the exception is eliminated or narrowed in the manner proposed, we anticipate that OMMs would be reluctant or even unable to effectively make markets on securities if they cannot be certain of their ability to establish and maintain an effective hedge and manage their risk through selling stock. The inability to make options markets would directly impact liquidity, capital formation and the every day investor. It would make capital formation more difficult because the options markets allow investors to transfer risk and, without that ability, equity investments will become considerably more risky. For example, an average investor who is long underlying equities and would like to hedge those positions by buying puts or selling calls would incur a greatly increased cost to hedge his portfolio if the options market becomes illiquid. Again, this would flow through to many more stocks that just the current threshold list. The impact would be significant, especially with increased volatility in today's markets.⁷

The re-proposal does not allay these concerns. The re-proposal suggests that the harmful impacts from eliminating or narrowing the exception may be minimal because: (i) the number of affected securities would be relatively small, (ii) the OMM hedge exception currently does not

⁶ A benefit of the OMM hedge exception is that it contributes to the maintenance of fair and orderly markets because it assists OMMs in their ability to continuously disseminate two-sided options markets with reasonable widths and sizes. Customers and firms have many reasons to utilize options, hedging specific issue, industry or portfolio risk, and OMMs ability to provide liquid markets is essential to that end. For example, every time a customer looks to sell deltas (sell call, buy puts; sell call spread; buy put spread) the OMM takes the other side of the trade. The OMM, in turn, needs to hedge the directional risk of that trade and that may entail selling the underlying stock. Protection of customers (for example, through buying puts or selling calls) is a top priority for many customers. Without the OMM hedge exception, making continuous markets would be very difficult, particularly in longer-dated options.

⁷ For example, given the recent activity in mortgage companies, investors in the underlying stocks naturally would seek to buy large put quantities. An OMM is required to facilitate investors by selling those puts and hedging with the underlying stock. If the stock is a threshold security or close to it, an OMM would have no choice but to significantly increase the options premium to cover his hedging risk and increased costs. There may also be instances where an OMM refuses to fill customer order flow for fear of assuming risk that could cause severe financial harm to the OMM and jeopardize his entire business.

apply to fails created *after* a security became a threshold security and, since the Commission is not aware of evidence that the current close out requirement for non-excepted fails in threshold securities caused harm in terms of liquidity, volatility, or short squeezes, so they do not think it would be a problem for fails created *before* the threshold date; and (iii) the initial 35-day phase-in period and ongoing 13-day close out requirement would mitigate potential harm.

We do not agree that the potential harms would be minimal. While it is true that the number of securities currently affected by the rule may be small,⁸ the application of the close out requirement to stock and options positions created before a security goes on the threshold list would be a radical change. The dynamic nature of the threshold list would have a ripple effect causing harm not only in threshold securities that are on the list, but in any security that may go on the list in the future. That “potential threshold list” is very large. Further, we do not believe that there has been no harm to the markets under the current structure. But even assuming there has been no harmful impact on post-threshold trading activity, applying the close out requirements to pre-threshold trading activity cannot simply be written off as being the same as restricting activity after something goes threshold. As indicated above, the result could affect market efficiency and capital formation, reduce the willingness of OMMs to make markets in the overlying options of securities that are or might become threshold securities, and result in decreased liquidity and increased costs to investors. The impact would be significant and distinct from the potential harms associated with post-threshold activity.

As for the proposed close out periods, the one-time phase in of 35 settlement days is particularly troubling because it would not be sufficient to account for pre-existing options positions that were assumed in reliance on the OMM hedge exception. To *ex post facto* impose a mandatory close out of offsetting short fails would substantially increase the risks and costs associated with longer term positions that were not anticipated at the time the options positions were originally undertaken. This is a concern for all previously exempt positions, particularly for positions associated with longer term options such as LEAPS®. Should the Commission decide to move forward with eliminating or narrowing the OMM hedge exception, we believe the phase-in period should be a period that corresponds to the related liquidation or expiration of the overlying options positions. As for the ongoing 13-day close out requirement for fail positions hedging OMM option activity, we have concerns that the timeframe may not be sufficient, particularly when considered in light of the elimination (or potential narrowing) of the exceptions, because it does not account for illiquidity. In addition, since OMMs tend to have similar positions, once a stock goes on the threshold list, there is likely to be a liquidity vacuum, which would be costly to market participants, including OMMs and the investing public.

The Commission also inquired whether fails attributed to hedging activities of OMMs should be treated differently from fails resulting from sales in the underlying stock markets and

⁸ Even though only a relatively small number of securities may be on the threshold list, some of them are very actively traded securities with active options trading and/or others are hard-to-borrow, making the need to be able to effectively hedge essential. Additionally, we have previously commented that exchange-traded funds (“ETFs”) and similar derivative products should not be on the threshold list because ETFs do not raise the same abusive short selling concerns. We continue to support a carve out for these products.

whether OMMs should be permitted to maintain a fail for an extended period or indefinitely when stock specialists are not able to do so. As a basic premise in support of maintaining the OMM hedge exception, we believe the Commission must appreciate the distinct differences between the nature of options market making and market making in the underlying stock. The risk of trading options on a threshold security is higher than that of a stock specialist. For example, in the underlying stock markets, there is often a natural flow of buyers and sellers to trade against each other without the stock specialist having to take a position. A stock specialist also does not normally hedge his stock. Instead, his risk is built into the price of the stock. This is not the case in the options market. An OMM routinely takes the other side of customer trades in an options transaction and must hedge the residual risk. Any short stock fails resulting from option hedges are not directional, which is the case for stock specialist sales. Further, stock specialists can satisfy Regulation SHO and cover their risk by simply buying back the stock. For OMMs, they would need to buy the stock and also worry about the risk and exposure for the options positions that were previously offset by that short stock. Managing this risk and exposure is not free – there are costs associated with getting long in the stock and trying to re-establish an adequate hedge of the related options positions. There would also be added risks and costs associated with longer-term options. Importantly, stock specialists are currently permitted to freely hedge their stock risk exposure with options (assuming a stock specialist desires to do so). However, OMMs are not permitted to freely hedge their options risk exposure with stock (even though that is an essential component of OMM risk management). Thus, the OMM hedge exception is actually a necessary offset to the close out requirements that levels the field between OMMs and stock specialists. It also balances the added risks associated with options market making not present for stock specialists. Elimination of the exception would leave an OMM at a considerable disadvantage compared to a stock specialist and cause significant disruptions in the markets moving forward.⁹

⁹ The re-proposal also indicated that, because OMMs may hedge on a portfolio basis as compared to a one-for-one basis, they may not be able to comply with the previously proposed amendments that would have required a close out when an option position is liquidated or expires. While OMM trading and hedging activity is extremely complex and dynamic – it may vary by a single trade, by strategy, by portfolio, etc. – we do not believe that is a reason to eliminate the OMM hedge exception altogether. OMMs can typically make hundreds, if not thousands of transactions per day and tracking the exception can be an extraordinary burden. That OMMs may hedge on a portfolio basis is a factor to consider in how complicated that may make the administrative burden of tracking pre-threshold options positions and related short stock hedges and adjustments and, more generally, whether the exception adequately and reasonably accommodates OMMs' and their clearing firms' needs. The Commission further indicated that OMMs may have an overly broad interpretation of the current OMM hedge exception that may be contributing to some securities having large and persistent fails to deliver. In particular, the Commission referenced the scenario where an OMM may "roll" a residual short stock position (which is attributable to pre-threshold options positions that have been liquidated or expired) to hedge post-threshold options positions. We disagree with the characterization of this practice as beyond the scope of what is permissible under Regulation SHO. Regulation SHO does *not* currently require the close out of fail positions attributed to pre-threshold options positions that have subsequently liquidated or expired. This topic was discussed with and agreed to by the Commission Staff in the course of preparing CBOE's Q&A Regulatory Circular RG06-14 (dated February 3, 2006). Because an OMM is explicitly permitted to retain a residual fail position attributable to the grandfather or the OMM hedge exception, it is *not* inconsistent with Regulation SHO to use that residual position to offset subsequently acquired options positions. If there is any confusion about the current application of the exceptions, that may be reason to clarify the particular requirements, which CBOE has worked with the Commission Staff to do on several occasions since the adoption of Regulation SHO. However, again, it is not a reason to eliminate the exception altogether.

We believe there is little chance that any perceived benefits from eliminating or narrowing the OMM hedge exception would be outweighed by the detriment the changes would have on the marketplace and added burden it would place on OMMs and their clearing firms.¹⁰ We understand that the Commission is faced with extreme pressure to target abusive naked short selling and, secondarily, to limit extended fails in threshold securities. However, there should not be a forced close out of OMM hedging-related fails irrespective of the consequences. It is impracticable and an overly broad means to address any potential abuses that could unnecessarily restrict legitimate OMM hedging activity and disrupt the efficient functioning of the markets and CNS.¹¹ It makes little sense to risk this result in order to eliminate extended fails in a small number of threshold securities, especially when the data demonstrates that the close out provisions appear to be operating as intended.¹²

For these reasons, we question whether the Commission needs to take the drastic measure of eliminating the OMM hedge exception. We are equally concerned with the proposed narrowing of the exception. If the Commission nonetheless believes that a change is necessary, we would prefer its proposed Alternative 1 (with some modifications) over Alternative 2.

¹⁰ The re-proposal indicated that potential benefits may include: (i) increased investor confidence in certain securities because fails to deliver can (a) deprive shareholders of the benefits of ownership (such as voting and lending), and (b) be seen as a sign of manipulative conduct; (ii) increased investor confidence in the settlement process; and (iii) a likely decrease in the number of threshold securities with high levels of persistent fails. Though we respect the desire to limit the instance of extended fails, we question the significance of the impact to shareholder ownership because, for example, shareholders are typically not permitted to lend securities (their clearing firms do). As for the concerns over potentially manipulative conduct, we note that short selling serves a legitimate purpose and reflects the market's negative views of a company's management or performance. What is more, hedging activity by OMMs is actually market neutral and not the type of activity that may raise investor confidence concerns in securities or the settlement process. With respect to the likely decrease in the number of securities with a high level of persistent fails, the elimination of the grandfather exception should significantly reduce persistent fails even further. And, there is no data showing that OMMs are responsible for the fails or that the sales are not bona-fide. See note 13, *infra*. We therefore question what overriding benefit could be gained that would justify the increased risk and expense associated with further restricting legitimate OMM hedging activity.

¹¹ Even those commenters who appear to support the proposed Regulation SHO amendment by far have based their arguments on the issue of abusive naked short selling, not on a concern with fails to deliver associated with the OMM hedge activity. Eliminating or narrowing the OMM hedge exception would simply prevent or unnecessarily restrict legitimate bona fide market making and hedging activity and artificially impact the market and, worse yet, may encourage other manipulative behavior or exacerbate negative consequences.

¹² The overall incidence of substantial, persistent fails in threshold securities is extremely isolated. The data gathered by the Commission reveals that the 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+5. The Commission also analyzed all stocks with aggregate fails to deliver of 10,000 shares or more utilizing various measures and found that all these measures showed declines in fails to deliver. Further, the Commission observed that the average daily number of securities on the threshold list was 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 persisted throughout the pre- and post-Regulation SHO period examined. For those six, fails to deliver declined by 68.6%. See the 2006 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). Additionally, there is no data showing that OMMs 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. See letter from the options markets to Nancy Morris, Secretary, Commission (April 30, 2007) referencing Securities Exchange Act Release No. 55520 (March 26, 2007), 72 FR 15079 (March 30, 2007)(the "Re-Opening of Initial Proposing Release") and comments of the National Association of Securities Dealers, Inc. (March 12, 2007).

Alternative 1 would provide that, for fails resulting from a hedge or an adjustment to a hedge of options series¹³ 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. The 13-day close out requirement would continue to apply to post-threshold date fail positions. Alternative 2 would provide that an OMM must close out the fail position resulting from a hedge or adjustment to a hedge of options series created before the threshold date within the earlier of (i) 35 consecutive settlement days from the threshold date or (ii) 13 consecutive settlement days from the date on which all options series within the portfolio that were created before the threshold date expire or are liquidated.¹⁴ Between the two choices, we believe Alternative 1 would be the easier to administer. However, we would propose that the number of days be increased from 35 to 42 consecutive settlement days. This change, though minor, is essential because it 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 the Commission believes 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.¹⁵ 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.¹⁶

“Long” Sale Documentation Requirement

The Commission has also proposed a requirement for broker-dealers to document the present location of securities being sold “long.” We believe this added requirement would create unnecessary administrative burdens and costs because clearing firms and self-regulatory organizations already have adequate procedures in place to monitor for proper marking of tickets that would not delay the processing of an order (as the anticipated documentation requirement may). We also believe that, should the Commission move forward with this aspect of the proposal, the Commission should consider incorporating various exceptions to the documentation requirement similar to what NASD had included in its former documentation rule, NASD Rule 3370(b).

¹³ The Commission inquired whether the meaning of the term “series” is sufficiently clear. We would interpret the term to mean a position in an individual series (e.g., being long the Sep07 45 calls in stock ABC).

¹⁴ The Commission inquired whether the meaning of the terms “expiration” and “liquidation” are sufficiently clear. We believe the term expiration is sufficiently clear. Based on guidance the Commission has previously offered under the existing OMM hedge exception, we understand that liquidation would be measured as of the end-of-day using FIFO.

¹⁵ 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.

¹⁶ 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.

This proposal is a matter of utmost importance to CBOE. We have undertaken a concerted review and discussed its potential impact with a broad cross-section of our market participants that would be directly affected by the proposal.¹⁷ For the reasons noted, we believe the Commission should not proceed with its proposals to eliminate the OMM hedge exception and to require broker-dealers to document the present location of securities being sold "long." We are more than happy to answer any questions on the foregoing or meet with you to discuss the proposed Regulation SHO changes further. Please do not hesitate to contact me, Jim Adams at 312-786-7718 or Jennifer Lamie at 312-786-7576.

Sincerely,



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
James A. Brigagliano, Associate Director, Division of Market Regulation
Josephine J. Tao, Assistant Director, Division of Market Regulation
Victoria L. Crane, Branch Chief, Division of Market Regulation

¹⁷ These market participants include, but are not limited to, Citigroup and Wolverine, both firms that actively operate as OMMs on CBOE and other options exchanges.