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December 23, 2008

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

Re: File No. S7-30-08

Dear Ms. Harmon:

The Chicago Board Options Exchange, Inc. ("CBOE") is submitting this comment letter on the release adopting an interim final temporary rule amending Regulation SHO and requesting comment on the same ("Release").[1] Rule 204T, the interim final temporary rule ("Rule"), is part of a series of actions taken by the SEC over the past several months for the stated purpose of addressing the potential for abusive naked short selling in equity securities during the financial markets turmoil occurring this year.

We understand the SEC was under immense pressure to take emergency action to mitigate the threat of manipulative activity in these extraordinary times in our financial markets. Unfortunately, the broad-sweeping actions taken by the SEC to pre-empt abusive naked short selling, and the manner in those actions were implemented, have had several unintended consequences on the markets and on market participants that are not the cause of the market crash. In the process, legitimate short selling activity (which serves to provide liquidity and price discovery) and the overall stock loan and delivery process (which operated very efficiently and effectively prior to the Rule) have been damaged. Of particular concern to us is the adverse impact this has had on the listed options markets and on options market makers' ability to perform bona fide market making responsibilities and manage risk.

As discussed below, CBOE believes that there are better and more efficient, targeted means to address abusive naked short selling than the Rule. In particular, we believe the existing regulatory and enforcement framework of Regulation SHO can effectively detect and deter such abusive activity, while not unreasonably burdening legitimate activity. Without evidence that the existing framework is fundamentally flawed, we see no reason for radical, long-term changes. But if the Commission determines to adopt the Rule on a permanent basis, then certain changes should be made to the Rule to remove some of its harmful side effects. In particular, we recommend that:

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[1] Securities Exchange Act Release No. 58773 (October 14, 2008), 73 Fed. Reg. 67106 (October 17, 2008).

- The close-out period for all persons should be increased to five settlement days after the date a fail to deliver position is incurred, instead of the current close-out timeframes;
- Close-outs on the last day for all persons should be permitted at any time, not just by the beginning of regular trading hours;
- An exception for de minimus fails to deliver should be recognized;
- Should the SEC retain the current close-out periods, then market makers (including options market makers) should still be given until the end of five settlement days after the date a fail to deliver position is incurred to close-out;
- The close-out procedures for fails attributable to bona fide market making should be amended to permit borrows or purchases throughout the close-out period;
- The SEC guidance on market making should make clear that bona fide conversion/ reversal activity by options market makers is permissible;
- Exchanges should be able to grant market makers (including options market makers) further relief to the close-out requirements when necessary to maintain fair and orderly markets; and
- The trade day for short stock positions resulting from an assignment or automatic exercise of options should be the next business day following the related exercise.

In addition, CBOE recommends that the SEC undertake a more deliberative and less ad hoc process when considering any further restrictions on short selling than has occurred over the past several months.

Comments on the Rule Generally

The steep and rapid decline in stock prices over the summer and fall resulted in the Commission issuing a series of emergency orders in July and September designed to place certain restrictions on short selling. Some of the emergency orders instituted strict requirements designed to prevent fail to deliver positions from sales of equity securities while others placed an outright ban on short sales of the equity securities of financial institutions. In addition, the SEC adopted a naked short selling antifraud rule and an amendment to Regulation SHO that eliminated the options market maker exception to the close-out requirements of Regulation SHO.[2] Rule 204T, which has been implemented for an extended temporary basis while it is being considered by the Commission, was originally issued as one of the emergency orders on September 17, 2008.[3] The Rule requires that participants of a registered clearing agency deliver

[2] Securities Exchange Act Release Nos. 58774 (October 14, 2008) and 58775 (October 14, 2008).

[3] Securities Exchange Act Release No. 58572 (Sept. 17, 2008), 73 FR 54875 (Sept. 23, 2008) (the "September Emergency Order"). Rule 204T is set to expire on July 31, 2009 and the Commission has indicated that further action is necessary by no later than the end of that period if the Commission intends to continue the same, or similar, requirements contained in the temporary

securities on a long or short sale in any equity security by settlement date, or if the participants have not delivered shares by settlement date, immediately purchase or borrow securities to close out the fail to deliver position by no later than the beginning of regular trading hours on the settlement day following the day the participant incurred the fail to deliver position.

While we recognize the SEC's intended goal is to eliminate the potential for abusive naked short selling, we believe that the Rule is a disruptive and overly restrictive means for doing so. Its impact has been to inject additional risk and uncertainty into market making and trading, add substantial expense and uncertainty to stock lending, and create impediments to hedging and arbitrage activities. In addition, the Rule has imposed enormous administrative and operational burdens on clearing firms, their customers and regulators. The amount of time and resources dedicated to deal with the Rule's impact on the delivery process, which operated very efficiently and effectively before the implementation of 204T, have been enormous. The changes engendered by the Rule have created undue burdens in several areas, including trading and risk management, clearing, lending and buy-in operations, as well as front-end trading, back-office and regulatory systems. Our members see the effects every day in the stock and options markets. Yet, we have seen no evidence that fail to deliver positions have contributed to the severe recent market downturn in a manner that justifies imposition of the restrictive provisions of the Rule, particularly for an extended period beyond the normal 30-day period that is allowed for emergency rules. Indeed, the stock market has continued to experience steep one-day price declines after implementation of the Rule on an emergency basis in September. On the other hand, we believe that the overly-broad structure of the enhanced delivery requirements for all equity securities has adversely affected the markets, unnecessarily resulting in increased market risk exposure for all market participants, including investors, an inability for market participants to effectively hedge that market risk, significant economic losses, increased costs and potential for short squeezes, increased volatility and decreased liquidity.

For example, we believe the recent escalation of mandatory buy-ins has been causing dramatic and uncharacteristic short-term price swings in many stocks, including optionable stocks, particularly at the opening. Using the week of December 8th through 12th as an example, we understand there were at least 20 instances where the opening price in hard-to-borrow option stocks jumped over 10% on the opening print only to drift back to around the previous day's closing levels within 10 minutes after the opening. In some cases the jumps were over 50% of the stock value:

- 61% in EPEX on December 9th
- 55% in CEM on December 10th
- 67% in GSAT on December 11th

These uncharacteristic price jumps were, almost certainly, the result of buy-ins being executed pursuant to the Rule. The impact these price moves have on opening option prices has become a significant concern for investors who rely on opening option trades to not be subject to undue

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rule. We anticipate before any such action would be taken that there would be notice and opportunity for public comment.

whipsaw volatility. As discussed below, the rule should be modified to avoid creating such whipsaw effects at the opening. Beyond these daily volatility concerns, the Rule's effects on stock lending have impacted the ability of market makers (including options market makers) to provide liquidity and manage risk, particularly for bona fide options market making in longer-term options and options on securities that are or might become hard-to-borrow.

While the Rule's mechanical restrictions may be intended to combat the potential for manipulative naked short selling behavior in the current economic crisis, the SEC should not impose a forced close-out of all fails irrespective of the consequences. We believe that any restrictions imposed by the Commission must be narrowly tailored so as to (i) target abusive activity and not unnecessarily constrain legitimate trading activity, (ii) avoid unintended impacts on investors and other market participants, as well as the efficient operation of the markets and the CNS system, and (iii) not result in permanent restrictions on trading activity once there is a return to normal market conditions. With these goals in mind, we recommend that the SEC consider eliminating the Rule and reverting back to the Rule 203(b)(3) short sale delivery requirements that were in effect before issuance of the emergency order (the so-called "threshold security provisions"). The threshold security provisions have worked as intended to reduce the amount of large and persistent fails to a tiny amount, while not imposing undue burdens where there are not concerns regarding settlement. Most trades settle within T+3 (over 99%) and, of the very small number of fails to deliver that do occur, the overwhelming majority settled within five settlement days after the fail is incurred. While we understand the intense political and media pressure on the SEC during this period of incredible market turmoil, we do not see a demonstrated need to take such broad-sweeping measures as the Rule on a permanent basis to address a miniscule amount of fails to deliver.[4] Additionally, the Commission's recently adopted Rule 10b-21 provides it with sufficient tools to attack any abusive naked short selling in a more focused and efficient manner.

Should the SEC choose to continue with the Rule, however, there are several actions it should take to reduce some of the unintended deleterious effects. First and foremost, the Commission should revise the timeframes for the Rule's close-out provisions. Currently, the Rule requires a close-out of a fail position from a short sale by the beginning of trading on the settlement day following the day the participant incurred the fail to deliver position and from a bona fide long sale on the third settlement day following the day of the fail. These time frames are very restrictive and do not provide a sufficient opportunity for clearing firms and the broker-dealers for whom they clear to react to a fail position in a measured manner, nor do they

[4] Under the threshold security provisions, a close-out was only imposed in threshold securities (securities with an aggregate fail to deliver position for five consecutive settlement days of 10,000 shares or more and that is equal to at least 0.5% of the issue's total outstanding shares) and only if a fail to deliver position persisted for thirteen consecutive settlement days subject to a limited exception for options market makers only with respect to hedges of options positions that existed prior to the threshold date. By comparison, under the Rule, all equity securities (whether or not they meet the threshold criteria) are subject to a close-out generally within one to three settlement days after the date the fail to deliver position is incurred and there is no exception to the close-out provision for market makers (including options market makers).

recognize that a de minimus level of fails may occur for any number of legitimate reasons that are not indicative of abusive naked short selling. The results are buy-in purchases on short notice and a tightening of stock loans and artificially-imposed escalations in lending rates and stock prices as clearing firms and the broker-dealers and customers for whom they clear need to be able to avoid being placed in the "penalty box" should a close-out not occur on time. We strongly support the recommendation of the Options Exchanges' comment letter on the Rule that the close-out requirements be modified so that clearing firm participants must take action to close out any fail to deliver position at a registered clearing agency that remains for five consecutive settlement days.[5] This extension of time would not result in extended fail to deliver positions nor facilitate abusive naked short selling, but should help alleviate some of the consequences of the current close-out provisions of the Rule.[6] For the same reasons, the Commission should recognize a de minimus exception to the close-out provisions. The exception could be set a minimal fail level, which we would be happy to work with the Commission to define, that would not be indicative of abusive naked short selling.

Issues Relating to Options Market Makers and the Options Markets

Should the SEC retain the current timeframes for close-outs under the Rule, then we urge the SEC to provide additional time for market makers (including options market-makers) to close out fail positions attributable to their activities. Relief should be provided in order to restore the ability of market makers to provide liquidity that evaporated over the past few months in large part as a result of the Rule. The Rule allows a participant of a clearing agency that has a fail to deliver position attributable to bona fide market making activities by a market maker (including options market makers) to close out the fail position by the beginning of trading hours on the third settlement day following the settlement date. We believe that additional time should be afforded to market makers to enable them to maintain tight quotes and provide liquidity. With respect to options market makers, we are concerned about the adverse impact on the options markets and options pricing arising from the added cost and risk associated with their ability to hedge or maintain a hedge with short stock positions that are subject to close-out by no later than the beginning of regular trading on the third settlement day after the date a fail to deliver is incurred. This is particularly the case given the restrictions in stock loans that have occurred as a result of the Rule. To address this concern, we believe there should be another two settlement day extension for market maker close-outs, so that the close outs would have to occur no later than the end of regular trading hours on the fifth settlement date following the date a fail to deliver position is incurred. This would enable options market makers to agree on reasonable close out arrangements with their clearing firms that would reduce the cost and uncertainty of

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[5] See comment letter from Options Exchanges to Florence E. Harmon, Acting Secretary, Commission (December 19, 2008).

[6] In addition, we believe close-outs should not be limited to occurring by no later than beginning of regular trading hours on the last close-out day because requiring close-outs in the morning unnecessarily and artificially creates more volatility. Instead, we strongly recommend that a close out be permitted at any time throughout the last close-out day and through other means, such as through VWAP orders.

hedging. Our recommendation for extended close out times for market makers is even more profound because Rule 204T imposes enhanced delivery requirements on all equity securities (not just threshold securities), on a more frequent basis than the threshold security provisions, and does not provide for an exception for hedging activity of options market makers.[7]

CBOE has several other recommendations for either modifications or clarifications to the Rule as it pertains to options market makers. First, we note that a discussion of bona fide market making in the release eliminating the options market maker exception to the threshold security rules contains an incorrect analysis that should be corrected in the next order the SEC issues with respect to the Rule. Specifically, footnote 99 of that release states that if a market maker sells a stock short together with a synthetic short position (i.e., a long put, short call position) and the client then sells the stock long while retaining the synthetic position, the effect would be as if the market maker had "rented" its locate exemption to the client, and thus not constitute bona fide market making by the market maker. We disagree strongly with this assertion. The example is confusing and does not appear to indicate any need or motivation for the client to "rent" a locate. Moreover, market participants regularly engage in reversal and conversion transactions. These are legitimate arbitrage transactions that are part of bona fide market making. Unless a market maker is acting in concert with the client so that the market maker knows that the client will improperly circumventing the rule, then the market maker is not facilitating a violation of the rule. Thus, selling or buying combination positions by a market maker should be deemed bona fide market making unless the market maker has knowledge that the client is improperly circumventing the rule.

Second, the close-out procedures for market makers need revision. The SEC's guidance on the September Emergency Order seemed to indicate, properly in our view, that the clearing participant could borrow or purchase the stock up until the beginning of regular trading on the third settlement day following a fail to deliver (e.g., S+3) to close out the fail position from a market maker.[8] The Rule, however, indicates that the clearing firm would have to make a

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[7] In the order eliminating the options market maker hedge exception to the threshold security provisions, the Commission recognized the potential for adverse impacts on liquidity, hedging costs, spreads and depth by eliminating the exception, but nonetheless concluded that the overall impact would be minimal in part because the threshold security provisions were limited to threshold securities and the options market maker hedge exception was only applied to pre-existing positions. With the introduction of Rule 204T (which applies to all securities on a more frequent basis and without a market making exception) the same concerns we previously raised become much more acute. See comment letters from Edward J. Joyce, President and Chief Operating Officer, CBOE, to Nancy M. Morris, Secretary, Commission (October 11, 2006 and September 17, 2007), and comment letter from Edward J. Joyce, President and Chief Operating Officer, CBOE, to Florence E. Harmon, Acting Secretary, Commission (August 15, 2008).

[8] See Question 4 of Division of Trading and Markets: Guidance Regarding the Commission's Emergency Order Concerning Rules to Protect Investors against "Naked" Short Selling Abuses (September 24, 2008).

purchase to effect the close-out rather than use a borrow. We understand that the SEC intended this to permit the participant to use a borrow on S+1 or S+2 to effectuate the close-out but force the participant to use a purchase on the morning of S+3. We recommend that the Commission make clear that the Rule enables a clearing participant to use a borrow on S+1 and S+2, and in addition, amend the rule to enable a borrow to be used on S+3 or until the amended closeout date. A stock borrow should be sufficient to close out the fail on any day up until and including the close-out date and has less impact on the market than a buy-in. As indicated above, we also believe that on the last close-out day, close-outs should be permitted throughout the day, not just in the morning.

Third, we believe that options exchanges should have the ability to provide exemptive relief to options market makers from the close-out requirements under both Rule 204T and 203(b)(3) on a case-by-case basis in order to maintain a fair and orderly market, similar to the same exemptive authority that stock exchanges have today for stock specialists under Rule 203(b)(3).[9] Given the elimination of the options market maker exception and the need to have parity with the stock exchanges, the expansion of the close-out requirements to all equities securities (not just threshold securities) and more limited timeframe in which close-outs must be applied, we believe it is imperative to have the ability to provide this relief to our options market makers.

Aside from recommendations with respect to the activities of options market makers, we have a recommendation to amend the Rule to prevent it from impeding the normal and efficient operation of the options markets. We believe that on a going forward basis that short sales from call assignments and automatic put exercises should be accorded some relief given the timing of when notice is received of such assignments, which typically occurs the next trade day, and automatic exercises, which typically occurs after the close on the date of the exercise (well after the stock loan window has closed). We believe that, for purposes of any short stock positions that may result due to an assignment or automatic exercise, the "trade day" should be the next business day after the related exercise occurs. This is consistent with guidance that the SEC staff has already confirmed with us with respect to assignments and we think it is reasonable and appropriate to treat automatic exercises in the same manner.[10]

Observations on the Emergency Orders

As noted above, during July through September the SEC issued a series of emergency orders on short sales. One of these orders imposed a ban on short sales in the equity securities of close to a thousand financial institutions. The order was issued spontaneously and became effective almost immediately, along with Rule 204T and a handful of other emergency orders. Unlike prior Regulation SHO initiatives that were subject to a deliberative process and had

[9] For additional details on the need to provide relief to options market makers as part of their bona fide market making and hedging activity, please refer to CBOE's prior comment letters. See note 7, supra.

[10] See CBOE Regulatory Circular RG08-113.

phased-in implementation schedules, market participants had no time to digest and understand the temporary short sale restrictions and enhanced delivery requirements before the markets opened, let alone adjust their trading, clearing and risk management systems to incorporate the new requirements and account for the increased market risks and costs. This was particularly troubling for the option markets because the orders were announced amid the Thursday and Friday of September's "triple witching" expiration, which of itself is already an extremely high volume trading day for options participants, and initially there was no clear relief extended to options market makers as part of their bona fide market making and hedging activities (even though relief had been extended to stock specialists to short stock in the U.S. and for options market makers by overseas regulators). At a volatile time when most turn to the options markets for liquidity and risk management, there was much confusion and uncertainty artificially introduced into the process. We do appreciate that the SEC Staff worked hard to address some of the unintended consequences after-the-fact. For example, an order issued on the Sunday after the September expiration extended a limited short selling exception to options market makers and provided some reprieve, but unfortunately that was not done before there was significant disruption through the options expiration cycle. The impact of these actions, and the fear of what emergency action might be taken next, continue to be a factor in liquidity providers' reduced willingness to provide markets and take on risk.

While the emergency orders have expired (though the markets continue to operate under some of the emergency provisions pursuant to "interim final temporary" rules), we think it is important to comment on some of the lessons learned from that episode. We make these observations with the recognition that the financial markets and its participants were under extraordinary strain during this period, and that financial regulators such as the SEC had an enormously difficult task in alleviating the chaos and stress infecting the markets. Nevertheless, we firmly believe that curtailing specific market behavior such as short sales through spontaneous emergency orders resulted in huge administrative and operational burdens for market participants, difficult implementation issues, and confusion and real risk exposure for market participants across the markets. The ability of an independent agency such as the SEC to act thoughtfully and in a deliberative manner during a time of market crisis is essential to maintaining market confidence. We do not think that the use of emergency orders to ban short selling and impose heightened delivery requirements on an ad hoc basis was consistent with this responsibility. To the contrary, the frantic pace of the emergency actions, and lack of advance notice and comment from the exchanges and market participants, may have contributed to additional confusion and uncertainty in the market that continues to reverberate.

In the future, should the SEC consider imposing renewed restrictions on short selling, we implore it to do so in a measured, careful manner with sufficient advance notice to the financial community and ample opportunity for exchanges and market participants to provide comments and input before implementation. If the SEC were to consider imposing a short sale "circuit breaker", "super tick test", or other measure designed to restrict short selling, it is essential that such measure be subject to the normal comment process and not be imposed on an emergency basis. Should for some reason the SEC determine to employ the emergency process again, however, we believe the SEC should keep in mind that: (i) there needs to be appropriate relief for liquidity providers in order for the markets to operate effectively; (ii) consideration needs to be made for the impact on market participants ability to hedge, particularly with respect to pre-existing positions (failing to accommodate these market participants can place additional risk and costs on the investor and clearing firm that were not anticipated); (iii) as much advance notice as possible is needed in order to address risk, operational and technical issues (the July emergency order is an example where a few days notice was provided and necessary adjustment were implemented in advance); and (iv) any requirement needs to be targeted and imposed for only a limited duration (we need to be able to return to normal market operations and should not subvert the regular rulemaking process).

We would be happy to discuss any of the issues in this letter further with the Commission. Should you have any questions regarding this letter, please contact me, 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 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 Market Regulation
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