CBOE
CHICAGO BOARD OPTIONS EXCHANGE

Edward J. Joyce
President and
Chief Operating Officer

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

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Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Release No. 34-60643; File No. 4-590
Securities Lending and Short Sale Roundtable

Dear Ms. Murphy:

The Chicago Board Options Exchange, Incorporated ("CBOE") is submitting this letter in response to the SEC's recent securities lending and short sale roundtable. Our comments focus on the discussion concerning the potential impact of imposing a pre-borrow or enhanced locate requirement on short sellers as a way to curtail abusive "naked" short selling (referred to herein as a "hard pre-borrow requirement"). As we have previously stated, CBOE emphatically disagrees with imposing any such additional restriction on short selling.

The vast majority of short selling activity involves legitimate, hedged positions that are integral to the markets. Abusive naked short selling – such as short selling used in conjunction with insider trading or short selling accompanied by false rumors designed to encourage others to sell (sometimes referred to as "short and distort" schemes) – is harmful to investors and to markets. Just like other kinds of market manipulation (such as manipulating a stock price upward through a "pump and dump" scheme), the SEC and SROs have an arsenal of weapons designed to address the potential for manipulative short selling activity. These include the federal anti-fraud and anti-manipulation provisions under the Exchange Act, and anti-fraud provisions specifically targeted to address the potential for abusive naked short sale activity under Rule 10b-21. Beyond that, there are prescriptive provisions under Regulation SHO designed to regulate all short and long sale activity – ranging from order marking requirements, to locate and pre-borrow provisions, to delivery and close-out requirements. These provisions serve to protect the integrity of the trading and settlement systems and to provide documentation that enhances oversight, surveillance and compliance. Given their prescriptive nature, these provisions are intended to target potentially abusive activity in a manner that does not unnecessarily burden the efficient and effective operation of the markets. For instance, under Rule 203, a locate simply needs to be performed prior to effecting a short sale subject to certain necessary exemptions, such as for stock and options market makers. It is only in instances where a fail-to-deliver occurs and persists that a pre-borrow requirement is imposed on the clearing firm and each of the broker-dealers for whom it clears (including market makers) until the fail-

to-deliver position is closed. The markets operate extraordinarily well under this framework, though it does impose certain costs and burdens.

In considering whether or not to impose a hard pre-borrow requirement that would impact all trading activity (whether long, short, buying or selling), it is important to first determine whether there is evidence that abusive naked short selling remains a problem and shortcomings in the existing regulatory framework. Only then should we consider how locate practices may contribute to the problem and whether a hard pre-borrow requirement would provide any meaningful incremental benefit. Unfortunately, the commentary seems to overwhelmingly focus on examining solutions without first clearly defining the problem or determining that there even is one. Case in point - objective analysis of the empirical data demonstrates that short selling was not a significant factor in last year's financial crisis and further confirms the legitimate and integral role short selling plays. Despite this analysis, the SEC continues to be pressed by a few commentators to further restrict short sale activity through various means, including the imposition of a hard pre-borrow requirement. However, the available data does not support the need for a hard pre-borrow requirement.

A few commenters that believe abusive naked short selling is a problem often cite fail-to-deliver stats as an indicator of the potential for abusive scenarios (though we are yet to see substantial empirical evidence of such abuses). These commenters also claim the imposition of a hard pre-borrow requirement will help to curb potential abuses. However, they fail to acknowledge that (i) fails-to-deliver can occur for a number of legitimate reasons, (ii) the imposition of a prescriptive pre-borrow requirement would have a significant impact on bona fide activity; and (iii) there are more effective, targeted means to address potential abuses. The only real effect of a hard pre-borrow requirement would be to prevent use of an easy-to-borrow list. There is no evidence that there have been abuses with use to the easy-to-borrow list. Moreover, to the extent they may serve as an indicator, the fail-to-deliver stats demonstrate that there are no systemic deficiencies in the settlement process and that abusive naked short selling is no longer a problem (assuming there ever was one). Over 99.9% of all trades settle within the standard T+3 settlement cycle. Moreover, Rules 204 and 10b-21 are specifically designed to address any concerns on the backend that those few fails-to-deliver which do occur (*i.e.,* roughly 0.01% of all trades) could persistent for any extended period of time or be indicative of abusive activity. Beyond that, the SEC and SROs can and do use other techniques such as electronic market surveillance, examinations and complaints to identify potential instances of manipulative naked short selling activity (just as they would for other types of market manipulation).

While the perceived marginal benefit (if any) to be derived from imposing a hard pre-borrow requirement is questionable at best, the costs and burdens would be significant - particularly because fails-to-deliver represent roughly only 0.01 percent of trades and only a small group of securities (*e.g.*, small market capitalization, thinly traded, or illiquid stocks) are likely to be targeted for a manipulative scheme. In addition, of those securities with fails, the vast majority are ETFs, which are unique and do not raise the same concerns about manipulation. The imposition of a hard pre-borrow requirement will lead to hoarding and additional costs (and inefficient uses of capital), and the potential for manipulation.

It is also important to note that, in conducting short sale reviews, the SEC and SROs have found that deficiencies generally are not indicative of systemic deficiencies or attempts to manipulate a security. In addition, we understand that the SEC did not see evidence of naked short selling (let alone manipulative naked short selling) or increased fails to deliver occurring in the publicly traded securities of 19 large financial firms when it issued its July 2008 emergency order to temporarily restrict naked short selling and fails to deliver in those securities (in fact, only 1 of the 19 was on the threshold list). Instead, the SEC was concerned about rumors that may have fueled volatility and that naked short selling could accelerate a price decline in a firm targeted by any such rumor.[1] In this regard, we understand that the SEC has initiated exams of the effectiveness of broker/dealers' and investment advisers' controls to prevent the spreading of false information.[2] We note further that analysis by the SEC's OEA indicates that the pre-borrow restrictions may have resulted in significant costs to all short sellers even those whose actions were not related to fails.[3]

Again, we would not support a hard pre-borrow requirement. If the Commission would take the extraordinary step of proposing a hard pre-borrow requirement, the approach must be narrowly tailored to target abusive naked short selling while not unnecessarily restraining legitimate activity, particularly activity that is critical for the maintenance of fair and orderly markets. Thus, any such proposal must contain exemptions for bona fide stock and options market making, as is already provided under the existing locate provisions of Rule 203. As discussed in our previous letters of July 19 and September 21, 2009, an overriding concern we have is the crippling impact prescriptive measures such as a hard pre-borrow requirement would have on the legitimate trading activity of options market makers. It would be impossible for options market makers to comply with a hard pre-borrow requirement. Without an options market maker exemption, options market makers would be prevented from being able to dynamically hedge with stock to manage the risks incurred in the course of performing bona fide market making obligations. The result would be a serious deterioration in options market quality, with less liquidity and wider bid/ask spreads. The options markets are vital to risk management and serve to reduce volatility in underlying markets. To perform their important market function, options market makers must have the ability to hedge the risks they assume, and to do so in an efficient manner. An exemption for the sole purpose of managing risk exposure of legitimate options market making is very limited, is consistent with the existing locate exemption, and would not cause any adverse impact (particularly in light of Rule 204's mandatory close-out requirement).

Over the last year, the SEC has implemented changes to enhance the delivery and settlement process (and further decreasing the potential for abusive naked short sale activity), increase transparency, and create a special anti-fraud rule specifically designed to address potentially abusive naked short sales. The SEC should acknowledge the integrity of these

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[1] *See* Management Comments to SEC Office of Inspector General Report on Practices Related to Naked Short Selling Complaints and Referrals (March 18, 2009)("Inspector General Report"); *see also* Securities Exchange Act Release No. 581666 (July 15, 2008), 73 FR 42379 (July 21, 2008).

[2] *See* Testimony of SEC Chairman Schapiro before the Subcommittee on Financial Services and General Government (June 2, 2009), http://www.sec.gov/news/testimony/2009/ts060209mls.htm.

[3] Memorandum OEA Analysis of the July Emergency Order Requiring a Pre-Borrow on Short Sales (January 14, 2009), http://www.sec.gov/spotlight/shortsales/oeamemo011409.pdf.

changes and its existing regulatory, compliance and enforcement framework, and should avoid imposing an additional, unnecessary hard pre-borrow restriction on legitimate short sale activity.

In conclusion, we object to any proposal to adopt a hard pre-borrow requirement. If any such test is ultimately proposed by the SEC, it is imperative that it contain an exemption for stock and options market makers for the same reasons that Regulation SHO contains such an exemption from the locate requirement today.

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CBOE again thanks the SEC for this opportunity to present our views in this ongoing discussion. Should you have any questions concerning CBOE's comments, please contact Joanne Moffic-Silver at 312-786-7462.

Sincerely,

Edward J. Joyce
President and
Chief Operating Officer

cc. The Honorable Mary L. Schapiro, Chairman
The Honorable Luis A. Aguilar, Commissioner
The Honorable Kathleen Casey, Commissioner
The Honorable Troy A. Paredes, Commissioner
The Honorable Elisse B. Walter, Commissioner
James A. Brigagliano, Co-Acting Director, Division of Trading and Markets
Daniel Gallagher, Co-Acting Director, Division of Trading and Markets
Elizabeth King, Associate Director, Division of Trading and Markets
Jo Anne Swindler, Acting Associate Director, Division of Trading and Markets
Josephine Tao, Assistant Director, Division of Trading and Markets
Victoria Crane, Branch Chief, Division of Trading and Markets