CBOE
CHICAGO BOARD OPTIONS EXCHANGE

June 19, 2009

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

Re: File No. S7-08-09

Dear Ms. Murphy:

The Chicago Board Options Exchange, Incorporated ("CBOE") is submitting this comment letter in response to the Securities and Exchange Commission's ("Commission" or "SEC") proposal examining whether to re-implement a short sale price test restriction.[1]

We feel compelled to state at the onset that CBOE does not believe a short sale price test restriction is a necessary, prudent or effective means to address market instability or prevent abusive activity. We are concerned that the drastic steps being proposed to address the potential for abusive naked short selling, although proposed with the goal of restoring investor confidence, would, in fact, undercut the stability and orderliness of our markets and further harm the investing public.

An overriding concern we have is the crippling impact any such restriction would have on the legitimate trading activity of options market makers. If a price test restriction is implemented, the proposal sets out at least five alternative tests.[2] With the exception of the circuit breaker ban alternative, there is no exemption proposed for bona fide hedging activities of options market makers. Absent an options market maker hedge exemption, the proposed price tests would significantly impede the ability of options market makers to legitimately perform bona fide market making obligations and manage risk. The result would be a serious

[1] Securities Exchange Act Release No. 59748 (April 10, 2009), 74 FR 18042 (April 20, 2009).

[2] In particular, the SEC has proposed two market-wide alternatives (a modified uptick rule based on the national best bid or an uptick rule based on the last sale price) and three circuit breaker alternatives (a circuit breaker would be triggered in a particular security if there is a 10% price decline and once triggered would for the remainder of the day either ban short sales, impose a modified uptick rule, or impose an uptick rule).

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deterioration in options market quality, with less liquidity and wider bid/ask spreads. Neither of these outcomes is desirable in face of the need to stabilize markets and restore investor confidence. Such a result can easily be avoided by providing an exemption for the hedging activities of options market makers in the same manner as the SEC has done in many other short sale rule contexts.

In the struggle for quick solutions in the midst of the recent severe market turmoil, short selling was immediately – and in our view unfairly - accused by some of accelerating last year's dramatic market downturn. Since then, objective analysis of the empirical data demonstrates that short selling was not a significant factor in the financial crisis, and further confirms the legitimate and integral role short selling plays in our capital market infrastructure. Even former SEC Chairman Cox, in retrospect, called the imposition of the short sale ban in September 2008 his "biggest mistake."[3] Despite the data, a populist and political drumbeat against short selling had already grown louder and continues to receive an inordinate amount of attention.[4]

In particular, the SEC has been under immense pressure to address the perception by some that short sale manipulation, bear raids, or other abusive naked short sale activity may have caused or contributed to recent substantial volatility and stock price declines. However, the SEC cannot meaningfully address investor confidence by applying politically expedient solutions to complex market mechanisms. In the process, legitimate short selling activity and the overall efficiency of our markets will be adversely impacted. Our common goal should be to curb abusive short selling practices without undermining the benefits of legitimate short selling.

A short sale price test restriction is not an effective means to address market instability or prevent abusive activity and will create more problems than it would purport to resolve. Although well-intended, such extreme and, we believe, mistargeted measures not only fail to address the very real regulatory issues of the day, they also throw sand in the gears of regulated exchanges, one of the few market systems that have actually performed well throughout the crisis. Legitimate short selling, such as the hedging activity by options market makers, has helped exchange markets to provide deep and continuous markets –without interruption - in the midst of unprecedented market turmoil.

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[3] Former Chairman Christopher Cox Interview with Washington Post (December 2008).

[4] The SEC's Division of Enforcement has stated that, "[i]n recent months, a small but vocal cadre of advocates has emerged decrying the practice [of naked short selling] and suggesting that it has damaging market effect. But there is hardly unanimity in the investment community or financial media on either the prevalence, or the dangers, of 'naked' short selling. . . . Still others pose the view the threat posed by 'naked' short selling is wildly exaggerated, and point to instances in which the allegations of abusive 'naked' short selling were used to cover up other management malfeasance, like the dumping on the market of large blocks of unregistered shares. [The SEC has] recently alleged such behavior in the widely-discussed CMKM Diamonds litigation. . . . Despite its assertions regarding the potential danger of 'naked' short selling and the growing interest in the subject, the [SEC's Office of Inspector General's Report] can cite to no bona fide studies or empirical data regarding the practice's market impact. The Division of Trading and Markets debunks the theory that [naked short selling] creates 'counterfeit' or 'phantom' shares. . . ." *See* Management Comments to SEC Office of Inspector General Report on Practices Related to Naked Short Selling Complaints and Referrals (March 18, 2009)(footnotes omitted) ("Inspector General Report").

Media reports suggest that the public dialogue on short selling has led investors to believe that restrictions on short selling will protect them from price declines. The government can unwittingly reinforce that mistaken belief through regulatory panaceas that respond to emotions and not to the facts. Effective market regulation protects fairness of opportunity in the market, not its up or down direction. Any regulation of short selling should have the objective of maintaining fair and orderly markets, not of preventing downward price adjustments. We do a disservice to investors to the extent that we let them think otherwise.

Whether viewed in the broader context of recent changes to Regulation SHO or in isolation, the case has not been made for the re-implementation of a short sale price test that would restrict legitimate trading activity (whether long, short, buying or selling).[5] If a price test is implemented, however, the SEC must provide an options market maker hedge exemption. Below are our views on the proposed short sale price test restrictions and why it is imperative that any price test adopted by the SEC include an exemption for hedging activity by options market makers. These comments are followed by more detailed explanations of an options market maker hedge exemption.

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SHORT SALES SHOULD BE PERMITTED WITHOUT A PRICE TEST

Short selling serves a legitimate role in the marketplace.

In order to restore investor confidence, it is important to note and distinguish the different types of short sale activity.

- *Short sale* - A sale of a security which the seller does not own or a sale which is consummated by the delivery of a security borrowed by the seller. Short selling is a legitimate and integral part of price discovery, aids liquidity, and contributes to capital formation and risk management processes as well as to fair and orderly markets.

- *Naked short sale* – A short sale where no arrangement is made to deliver the stock at settlement. Not all naked short selling activity is abusive or illegal. Naked short selling can occur for a number of legitimate reasons, without any sort of manipulative or abusive intent. The mere fact that a stock may experience failures to deliver does not imply a violation of federal securities laws.[6]

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[5] Rule 10a-1 (the former uptick rule) and SRO price tests were eliminated in 2007 after empirical research by the SEC and academics showed that short sale price tests do not effectively serve their purpose, but do impose costs on the markets. As Commissioner Parades noted, "[i]t is not self-evident that the findings of these economic studies – which supported the [SEC's] prior decision to repeal the 'uptick' rule – do not continue to hold in the current economic and financial climate." *See* Statement of Commissioner Troy A. Parades before the Commission Open Meeting (April 8, 2009), http://www.sec.gov/news/speech/2009/spch040809tap.htm.

[6] Generally long and short stock sales are completed with the delivery of stock shares that are owned or borrowed within three settlement days of the trade date (or "T+3"). Shares that are not delivered by T+3 are referred to as *fails-to-deliver* or *fails*. A fail may occur as a result of a long sale or short sale.

- *Abusive short selling* – Abusive short selling practices, including *abusive naked short selling*, involve fraud and/or market manipulation. Examples include short selling used in conjunction with insider trading and short selling accompanied by false rumors designed to encourage others to sell (sometimes referred to as "short and distort" schemes). Abusive short selling, like other kinds of market manipulation (such as manipulating a stock price upward through a "pump and dump" scheme), is harmful to investors and to markets.

We agree that abusive short selling activities, including abusive naked short selling, should be and are subject to vigorous regulation and enforcement. We are equally emphatic about the important role that legitimate short selling serves in the marketplace. Markets are the vehicle for investors to act on their views regarding the value of a stock. Markets that allow short selling tend to have more efficient price discovery and therefore attract more capital. Without short selling many market participants would be prevented from acting on their view that a stock is overpriced. According to Arturo Bris of Yale, "previous research has shown that markets which prevent or do not practice short sales are characterized by poor information diffusion and price discovery. While stocks in these markets might be slightly less prone to extreme price drops, they are also less efficiently priced."[7] Short selling can also increase liquidity by increasing the number of active traders in a stock. Short sellers are often willing to trade when other investors would not. This increase in trading facilitates the price discovery process and can narrow the bid/ask spread by encouraging aggressive bidding.

Regulators from around the world have acknowledged the important role of short selling. The International Organization of Securities Commissions ("IOSCO") believes that "short selling plays an important role in capital markets for a variety of reasons including more efficient price discovery, mitigating price bubbles, increasing market liquidity, facilitating hedging and other risk management activities."[8] This is not to suggest that short selling cannot be abusive. For example, IOSCO has also indicated that "there is also a general concern that, especially in extreme market conditions such as we have recently experienced certain types of short selling or the use of short selling in combination with certain abusive strategies may contribute to disorderly markets." As we indicated above, abusive short selling activities should be and are subject to vigorous regulation and enforcement. However, the re-implementation of a prescriptive short sale price test is not a necessary or appropriate method for doing so.

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[7] Arturo Bris et al., *Short-Sales in Global Perspective* (December 9, 2003), http://faculty.som.yale.edu/~ab364/ssglobal.pdf.

[8] *See* accompanying media release to Regulation of Short Selling, Consultation Report by the IOSCO Technical Committee (March 23, 2009). In November 2008, the IOSCO Technical Committee launched three task forces to support G-20 aims and to craft a detailed work program to address the recent market turmoil, focused on strengthening financial markets and investor protections. The subjects addressed by the task forces related to short sales, unregulated financial markets and products, and unregulated financial entities. The short sale task force worked to eliminate gaps in various regulatory approaches to naked short selling, including delivery requirements and disclosure of short positions. The task force also examined how to minimize adverse impacts on legitimate securities lending, hedging and other types of transactions critical to capital formation and reducing market volatility. *See* SEC Chairman Cox Statement on Meeting of IOSCO Technical Committee (November 24, 2008), www.sec.gov/news/press/2008/2008-279.htm.

Short selling is not the cause of the extreme market conditions we have been experiencing over the last 18 months.

There may be a human inclination to infer causal relationships between events that occur sequentially in time. However, the fact that the financial crisis emerged shortly after the elimination of the uptick rule does not support any conclusion that a connection exists. The SEC will undoubtedly receive comments from some investors, lobbyists, and others, suggesting this connection.

Although a full understanding of the financial crisis may be years away, it should be clear that the subprime mortgage crisis and credit crisis were the primary triggers for the steep price declines and increased volatility in the markets. Short selling neither caused the crisis nor contributed to it in any significant way. Consider, for example, the SEC's emergency order banning short sales in financial sector stocks, which was issued on September 18, 2008 and was in effect from September 19 through October 8, 2008.[9] Financial stocks continued to fall during the short sale ban and data indicates that selling pressure on the markets came primarily from sellers who were long the stocks. According to a Credit Suisse research report, restricted financial stocks actually performed better than the market prior to restrictions being imposed. If short sellers had targeted these stocks they should have sold off more than the market while short selling was still allowed.[10]

It is important that any decisions to alter the structure of U.S. markets be based on facts and data, and not driven by emotional or political pressures. As was recently noted in a letter from various U.S. Senators, "[s]hifting the SEC's approach to rulemaking from relying on quantitative economic analysis to an emphasis of market psychology would be a significant departure and raise many questions. . . . Instead of imposing blanket restrictions that will negatively impact liquidity, price discovery, and spreads, the Commission should focus on specific abusive trading conduct that is clearly defined and provides measureable results."[11]

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[9] Securities Exchange Act Release Nos.58592 (September 18, 2008), 73 FR 55169 (September 24, 2008); 58611 (September 21, 2008), 73 FR 55556 (September 25, 2008); and 58723 (October 2, 2008), 73 FR 58987 (October 8, 2008).

[10] *Ticking off the Shorts*, Credit Suisse Report (April 23, 2009). It is also important to note that, according to Credit Suisse, the overwhelming majority of short selling occurs as part of a hedging strategy that seeks to pair a short trade with a similar long position. The goal is not to drive down the price of the short stock but, to capture any relative mispricing between the two. Credit Suisse notes that less than 1% of hedge fund strategies are dedicated short.

[11] *See* letter from Senators Mike Crapo, Jim Bunning, David Vitter, Michael B. Enzi, and Mel Martinez to SEC Chairman Mary Schapiro (June 17, 2009).

The existing Regulation SHO framework can effectively detect and deter abusive short selling activity.

As adopted in 2005, Regulation SHO prescribed order marking and locate requirements for all equity securities,[12] and close-out requirements for threshold securities.[13] In addition, the SEC also relied upon the federal securities general anti-fraud and anti-manipulation provisions to address abusive short selling.

In part, the philosophy behind Regulation SHO was that, by targeting threshold securities, it would not burden the vast majority of securities where there were not similar settlement concerns. The data made available by the SEC overwhelmingly demonstrates that these rules have worked well to reduce the amount of large and persistent fails to an infinitesimal amount.

- More than 99% of all trades settled on time within T+3. Of the less than 1% of trades that fail, more than half of all fails to deliver and 70% of all fail positions closed out within two settlement days after T+3, and the vast majority settled within five days after T+3.

- The average number of securities on the threshold list remained at well less than 1% of all equity securities (the SEC had initially anticipated that about 4% of all securities would qualify for the threshold list). Of those, the number associated with optionable securities was even lower and the majority of "persistent" threshold securities were ETFs and similar products that do not raise the same abusive short selling concerns.

- New fails to deliver in threshold securities have accounted for well less than 0.5% of all market volume – this has been the case since January 2005 and more recently the level is below 0.1% .[14]

The positive figures above existed *prior* to the enactment of various changes to Regulation SHO, including several changes enacted in September 2008. Significant among these recent changes are the following:

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[12] *See* Rule 200(g) of Regulation SHO, which contains uniform *long* and *short* order market requirements for sales of all equity securities, and Rule 203(b), which requires a broker-dealer to have reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due before effecting a short sale order in any equity security (the *locate* requirement). Broker-dealers engaged in bona-fide market making are excepted from having to locate shares.

[13] Under Rule 203(b), 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*. The rule requires that failure to deliver positions in threshold securities that have persisted for 13 consecutive settlement days to be closed out buy purchasing securities of like kind and quantity. Until the position is closed out, further short sales may note be effected in that threshold security without borrowing or entering into a bona fide agreement to borrow the security.

[14] *See* Figure 4 to the United States Government Accountability Office Report to Congressional Requesters regarding Regulation SHO (Recent Actions Appear to Have Initially Reduced Failures to Deliver, but More Industry Guidance is Needed) (May 2009) (the "GAO Report").

- The Commission adopted Rule 10b-21, an anti-fraud rule that should aid efforts to attack any abusive naked short selling in a more focused and efficient manner.

- The Commission adopted first on an emergency basis, then on an interim final temporary basis, a rule requiring reporting of short sales and short positions in certain securities, Rule 10a-3T.

- The Commission imposed heightened delivery requirements through Rule 204T for all equity securities on an emergency basis, then on an interim final temporary basis.

The Commission implemented Rule 204T because of a concern about the potential impact persistent fails could have on market confidence, although the fails were not necessarily the result of illicit activity, such as abusive naked short selling. The Rule, which essentially replaces the threshold security close-out process, requires a close-out of a fail position from a short sale in any equity security 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. The rule also contains special accommodations for market makers, including options market makers, permitting them to close-out on the third settlement day following the day of the fail.

Rule 204T has been successful in further reducing the already *de minimis* fail levels (*e.g.*, 99.9% of trades now settle on time; fails across all securities have declined by 56.6% and in threshold securities have declined by 73.5%; the average daily number of threshold securities, which was already well less than 1% of all equity securities, have declined by 77.5%; and the number of threshold securities underlying listing options have declined by 82.1%).[15] While CBOE and the other options exchanges continue to support modifications to Rule 204T to better balance concerns about potentially abusive short selling against the need for market efficiency,[16] we recognize that the new settlement requirements imposed by Rule 204T in effect eliminate the ability to maintain a fail to deliver position (whether long, short, legitimate or otherwise) and therefore remove a potential tool for abusive short sellers.

The SEC should recognize the impact of temporary Rules 204T and 10a-3T (as well as Rule 10b-21) in addressing the potential for abusive short selling. The SEC should consider adopting some form of these rules on a permanent basis and defer consideration of further restrictions on short selling.[17]

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[15] Memorandum from Office of Economic Analysis ("OEA") Re: Impact of Recent SHO Rule Changes on Fails to Deliver (April 16, 2009), http://www.sec.gov/comments/s7-30-08/s73008-121.pdf.

[16] *See* letters from CBOE to Florence E. Harmon, SEC (December 23, 2008) and from the options exchanges to Florence E. Harmon, SEC (December 19, 2008) (both letters relate to the interim final temporary order and notice for comment on Rule 204T).

[17] Some commenters have argued that the stricter close-out requirement does not prevent manipulative naked short sale activity from occurring within the 3-day settlement cycle and, rather than a short sale price test, have recommended a pre-borrow requirement. We emphatically disagree with any such requirement. The costs of a pre-borrow would far outweigh any perceived benefit, particularly because fails to deliver represent only 0.01

The case has not been made for the re-implementation of a short sale price test.

After undertaking a very deliberative process to examine the overall effect of price tests on short selling, liquidity, volatility and price efficiency, the SEC eliminated Rule 10a-1 and other SRO short sale price tests in 2007. At the time, the view was that price test restrictions are no longer necessary because markets are subject to higher levels of transparency and regulatory surveillance. In addition, general anti-fraud and anti-manipulation provisions would continue to prohibit and deter activity designed to improperly influence a security's price. Market developments, such as technological innovations and decimalization, had also transformed the trading landscape since Rule 10a-1 was first adopted and changed the impact of price test restrictions. As Commissioner Casey has noted, OEA also found that removing the price tests had a material effect on short selling volume, the mechanics of short selling, order routing decisions, displayed depth, and intraday volatility, supporting the view that eliminating the price tests would reduce these market distortions. OEA also tested for signs of "bear raids," but found no indication that removing the price tests was associated with increased manipulation.[18]

We see no compelling reason to discard the prior analysis nor are we aware of any credible empirical evidence demonstrating that the elimination of the price test drove down the price of any security. Re-implementation of a short sale price test restriction would unnecessarily restrict legitimate trading activity and should not be adopted merely to dissuade general concerns about investor confidence. The SEC should not re-implement a price test unless it is supported by substantial and compelling data, and unless identified benefits of the regulation would exceed the substantial costs it would impose.

percent of the dollar value 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 manipulative scheme. Instead, 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). *See* GAO Report, note 14, *supra*. In addition, the Commission's recently adopted Rule 10b-21 provides it with sufficient tools to attack any such abusive naked short selling in a more focused and efficient manner. It is 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. 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 the 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. *See* Inspector General Report, at note 4 *supra*, *see also* Securities Exchange Act Release No. 581666 (July 15, 2008), 73 FR 42379 (July 21, 2008). 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. *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. We note further that analysis by 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. 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.

[18] Statement of Commissioner Kathleen L. Casey before the Commission Open Meeting (April 8, 2009), www.sec.gov/news/speech/2009/spch040809klc.htm.

If a price test is implemented, the SEC must provide an options market maker hedge exemption.

If a price test is adopted, it must be narrowly tailored to target abusive short selling while not unnecessarily restraining legitimate trading activity, particularly activity that is critical for the maintenance of fair and orderly markets. Of particular concern to us, there must be an exemption for bona fide hedging by exchange-registered options market makers, if not for all legitimate hedging, stock and convertible market making, and arbitrage transactions, in order to avoid further disruption to the markets.[19] Currently, among the various price test alternatives, only the circuit breaker ban explicitly contemplates a market maker hedge exemption. It is critical that the Commission include an options market maker hedge exemption for <u>any</u> price test restriction that may ultimately be imposed.[20]

Options market maker exempted activity would be limited to hedging. A hedge exemption for the sole purpose of managing risk exposure of legitimate options market making is very limited and would not cause any adverse impact on the markets for securities underlying listed options or on stock market makers. Options market makers assume stock positions to hedge options positions obtained in the course of bona fide market making activity, in an effort to remain market neutral. Options market makers have no incentive to force the price of a stock lower. Doing so when trying to initially establish a hedge would result in an inferior hedge. Absent an exemption, the proposed price tests would inhibit efficient hedging by options market makers. The lack of a hedge exemption that allows options market makers to quickly effect short sales in stocks underlying the options in which they make markets will result in inferior posted markets and higher options costs to all investors.

The exemption should be modeled after the options market maker hedge exemption from NASD's (now known as FINRA) former short sale bid test, which was in place for nearly 10 years prior to Regulation SHO.[21] Under that exemption, an NASD member could execute a

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[19] We may comment in the future upon any specific proposals for such exemptions, but our comments are focused on the need for an options market maker hedge exemption. Irrespective of what the SEC decides for these other legitimate activities, it must provide an exemption for bona fide hedging activity for options market makers.

[20] If a price test is implemented, the Commission should also clarify that all option assignments and exercises (whether or not automatic) would be exempt from any price test. We believe this is implicit in the proposal because the exercise/assignment process takes place in the after hours market and for the other reasons set forth in the options exchanges' June 19, 2009 comment letter. As for the particular price test alternatives, we support a circuit breaker model because it would be targeted to address only those instances of severe price declines where abusive short selling activity arguably might contribute to disorderly markets. We also prefer a "policies and procedures" approach, consistent with Regulation NMS philosophy. As for each of the circuit breaker alternatives, we believe the benchmark for a circuit breaker should be the opening price, which would take into account after hours news and avoid disorderly openings, particularly on options settlement dates. If the prior day's close is used, it should be made clear that the price test is not applicable to opening trades. Finally, without knowing the particular test and related exemptions, it is difficult to assess the implementation period for members, the exchanges and the SIP to develop, program, test and launch the operational, administrative and compliance-related changes. We also anticipate that rule changes may be necessary. Based on our initial assessment, we do not believe that three months will be sufficient to implement changes that would necessitate an industry-coordinated effort.

[21] Securities Exchange Act Release No. 34277, 59 FR 34885 (July 7, 1994); *see also* Securities Exchange Act Release No. 33289, 58 FR 64994 (December 10, 1993).

short sale for the account of an equity or index options market maker so long as: (1) the short sale was an "exempt hedge transaction";[22] and (2) the options market maker was registered with a "qualified options exchange"[23] as a "qualified options market maker" in a stock options class overlying a NASDAQ National Market ("NNM") security or in an options class overlying a qualified stock index. This options market maker hedge exemption from the NASD short sale price restrictions in NASDAQ stocks functioned well from a regulatory standpoint and would operate well under any of the alternatives being considered. We discuss below the compelling reasons to provide an analogous exemption from any of the SEC's proposed price tests.

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FUNDAMENTAL REASONS FOR AN OPTIONS MARKET MAKER HEDGE EXEMPTION

The options markets are vital to risk management.

The U.S. options marketplace is the largest listed options market and the eleventh largest securities market in the world.[24] Its services are used by hundreds of thousands of retail and institutional investors – including mutual funds, retirement accounts and pension funds - who depend on the benefits of its risk management products, coupled with the security of public price dissemination, continuous markets, centralized clearing and margin. With 2008 traded volume

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[22] An "exempt hedge transaction" was defined to be a short sale in a NNM security that was effected to hedge, and in fact served to hedge, an existing offsetting options position or an offsetting options position that was created in a transaction(s) contemporaneous with the short sale, provided that when establishing the short position the options market maker received, or was eligible to receive, good faith margin pursuant to Section 220.12 of Regulation T under the Act. For index option market makers, an "exempt hedge transaction" was defined to be a short sale in a NNM security that was effected to hedge, and in fact serves to hedge, an existing offsetting stock index options position or an offsetting stock index options position that was created in a transaction(s) contemporaneous with the short sale, provided that: (1) the security sold short must be a component security of the index underlying such index option; (2) the index underlying such offsetting index options position is a "qualified stock index"; and (3) the dollar value of all exempt short sales effected to hedge the offsetting stock index options position(s) does not exceed the aggregate current index value of the offsetting options position(s).

[23] A "qualified options exchange" was defined to be a national securities exchange that had received SEC approval of its rules and procedures governing: (1) the designation of options market makers as qualified options market makers; (2) the surveillance of its market makers' utilization of the exemption; and (3) authorization of the NASD to withdraw, suspend, or modify the designation of a qualified options market maker in the event that the options exchange determines that the qualified options market maker had failed to comply with the terms of the exemption and the exchange believed that such action was warranted in light of the substantial, willful, or continuing nature of the violation. All national securities exchanges that traded standardized options were "qualified options exchanges." These standards helped to ensure that qualified options market makers continue to engage in market making activities in their assigned options, while not allowing the market maker exemption to be extended beyond its original purpose, and ensure that short sales effected by qualified options market makers are exempt hedge transactions and that other non-qualified market makers are not using the exemption. In addition, to help ensure that the options market maker exemption would not have an adverse market impact on NASDAQ, ISG, among others, served as a vehicle for the markets to evaluate possible manipulative activity and other possibly market destabilizing short selling activity by qualified options market makers and other options market makers.

[24] *See* World Federation of Exchanges 2008 Annual Report.

of over 3.583 billion contracts,[25] its notional turnover in terms of shares exceeds the total equity market volumes of such global financial capitals as Germany, Canada and many other developed economies. The U.S. options market supports seven exchanges, hundreds of market makers, and thousands of brokerage firms. Unlike over-the-counter and more exotic derivatives, all listed options contracts are "standardized,"[26] listed, traded and reported on open, national securities exchanges and are cleared by a single, AAA-rated clearing entity, The Options Clearing Corporation. The industry offers options overlying over 3,800 different securities and indexes, with nearly 340,000 products currently available.

- ***The options marketplace is primarily a risk management mechanism for investors.*** When used in conjunction with other investment strategies or securities, options provide a mechanism to manage the risk associated with equity ownership. Options can also serve to reduce volatility in underlying markets. The ability to use options provides holders of stock and stock portfolios with the power to tailor risk tolerance without abruptly having to buy or sell their holdings, thus reducing price volatility, encouraging long-term stock ownership and providing balance to the marketplace. Similar to the way that insurance enables businesses to conduct operations without fear that random events may jeopardize their enterprise's existence, the options market allows stock holders to focus on the long-term outlook for their holdings without undue concern over short-term events and volatility. Because investors can use listed options products to hedge and manage the risks of their stock positions, they are more willing to invest in the stock market and provide capital for public offerings.

- ***In order to enable investors to have the capability to manage risk, the listed options market needs to have professionals willing to take the other side of their trades and contribute capital to maintain liquid markets in the options underlying these stocks.*** These professionals are the options market makers. Pursuant to SEC rules, options market makers have one basic function – they buy options when customers wish to sell and sell options when customers wish to buy. To perform this function they must have the ability to hedge the risks they assume, and to do so in an efficient manner and at a minimal cost. The primary means available to options market makers for hedging is the underlying equity market. This may be the underlying stock of each option itself (e.g., IBM stock for IBM options) or an index based on securities (e.g., S&P 500 Index). If options market makers find it difficult or costly to hedge in these instruments, only the unwise or imprudent would be willing to serve as options market makers and provide such risk management services. If options market makers do not have the ability to buy and sell sufficient quantities of stock in an efficient manner and at a reasonable price, they will be forced to pass on these inefficiencies to their end customers.

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[25] One equity options contract is generally equity to 100 shares in the underlying security, unless adjusted for a special event such as a stock split or stock dividend.

[26] *Standardized options* are options contracts trading on a national securities exchange, an automated quotation system of a registered securities association, or a foreign securities exchange which relate to options classes the terms of which are limited to specific expiration dates and exercise prices, or such other securities as the Commission may, by order, designate. *Standardized options* are subject to the options disclosure document requirements of SEC Rule 9b-1.

To understand the points made above it is helpful to describe an example of a typical options trade between a customer and an options market maker. Take a customer whose income is primarily dependent on a dividend producing portfolio of five of the top U.S. equities (Home Depot, General Electric, Caterpillar, MMM and Proctor & Gamble). Assume the individual desired to purchase put options on 1,000 shares each of Home Depot, General Electric, Caterpillar, MMM and Proctor & Gamble. Assume further that the customer desired to purchase put options with an exercise, or strike price equivalent to each stock's current market price minus 10%, and for an identical time period of 5 months. In insurance terms, this would be synonymous with purchasing an insurance policy with a 10% deductible for a 5 month term. In the case of Proctor & Gamble, for example, that would imply purchasing 10 put options (each listed option covers 100 shares of stock) for expiration in October 2009 with a strike price of $47.50/share (PG stock is currently trading at approximately $52/share). The customer would submit this order to the options market, where an options market maker was showing a market of $1.85 bid - $1.95 offer. The options market maker is obligated to post both a bid and an offer for each option, and, must be willing to buy or sell dependent on the customer's needs. The prices quoted for options are "per share," so the PG November 47.50 Put options cost $195 each to buy, as each option is for 100 shares. This price or the "premium," is paid by the buyer of the contract (the customer in this case) to the seller (the options market maker).

At that point, the transaction for the customer is finished. They have purchased their put options, and may now rest assured knowing that they are protected from loss in their PG stock position below $47.50/share. This is a preferable outcome to the alternative, which is that they sell their holdings and contribute to downside pressure on the stock. For the options market maker, however, there is another part to this transaction. They have now "insured" the customer's stock position below $47.50/share and thus need to hedge this liability or risk assuming the profile of an uncovered insurer. To offset the risk from that position, the options market maker will need to establish a short position roughly equivalent to the risk he now assumed. That does not entail selling short 1,000 shares of PG, as the full risk does not come into play until the stock goes below $47.50/share. Instead, the options market maker sells short a lesser amount on a delta equivalent basis.[27] In this case assume a 30 delta, which would be 300 shares or 30% of the equivalent stock position. If the stock remains at or near its current level of $52 for the remainder of the options term, no further short selling of PG stock by the market maker to hedge would be necessary, and the market maker would eventually close out that short position with a buy order. The end result is that the customer obtained insurance for 91% of their $52,000 PG stock position cash value for a 3.75% premium; the market maker collected the $1,950 premium as compensation for their assumption of the risk; the market avoided a full

[27] The price of an option is not completely dependent on supply and demand, nor on the price of the underlying security. Market makers price options based on basic measures of risk as well. One of these such measures, delta, is the rate of change in the price of an option as it relates to changes in the price of the underlying security. The delta of an option is measured incrementally based on movement in the price of the underlying security. For example, if the price of an option increases or decreases by $1.00 for each $1.00 increase or decrease in the price of the underlying security, the option would have a delta of 100. If the price of an option increases or decreases by $0.50 for each $1.00 increase or decrease in the price of the underlying security, the option would have a delta of 50.

(long) sale of the 1,000 shares held by the customer, and instead absorbed only a far smaller short sale due to the hedge by the market maker.

This example, while simplistic, is typical of the majority of options trades that are conducted each day in the listed options market. It illustrates the need for the product itself, for the efficient marketplace of the underlying, for the role of the market maker and for the capability to sell short without undue restriction. In the preceding example, had there been, to one extreme, a total inability to sell the underlying stock short, the options market maker would simply have not been able to offer the put options desired by the customer (or would only have been able to offer them at a much higher price), and the customer would have little choice to hedge their risk but to sell their stock. If there had been restrictions on short selling, perhaps limiting the short sale to a tick test or other artificial barrier, the customer would have had to pay more for the insurance to make up for the additional cost imposed on the market maker to hedge their position.

An options market maker hedge exemption would contribute to market stability and promote investor confidence.

The reasons for a short sale exemption for options market makers have been expressed in previous letters to the Commission by CBOE and the other options exchanges.[28] Foremost among the many reasons for an exemption are the following:

- ***Options market making obligations are the basis for an exemption.*** Options market makers must be members of a national securities exchange, meet certain net equity/capital requirements, and have their activity subject to SEC and relevant SRO oversight. The rules of the SEC and the options exchanges impose significant affirmative and negative obligations on options market makers. In addition, the spread between an options market maker's quoted bid (price willing to buy) and offer (price willing to sell) may not exceed set limits, the quote size must meet certain minimum amounts, and the quotes themselves must be continuously quoted in a minimum number of series within each options class. 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 and demand, and maintain appropriate price relationships between options of the same class. In order for options market makers to uphold these responsibilities, it is crucial for them to be able to efficiently buy and sell stock to dynamically hedge the risk of performing these important market functions.

- ***Options market maker exempted activity would be limited to hedging.*** The exemption CBOE is proposing would be solely limited to hedging, and as such would be utilized only when selling stock short to hedge the long market exposure of options positions undertaken as a result of options market making activity. Therefore, any gains on a short stock position would be offset by losses from long market exposure in the options, leaving an options market maker with no motive to engage in speculative short selling to drive the price of the

[28] *See, e.g.*, letter from options exchanges to Jonathan G. Katz, SEC (February 9, 2004)(regarding the SEC's Regulation SHO proposal).

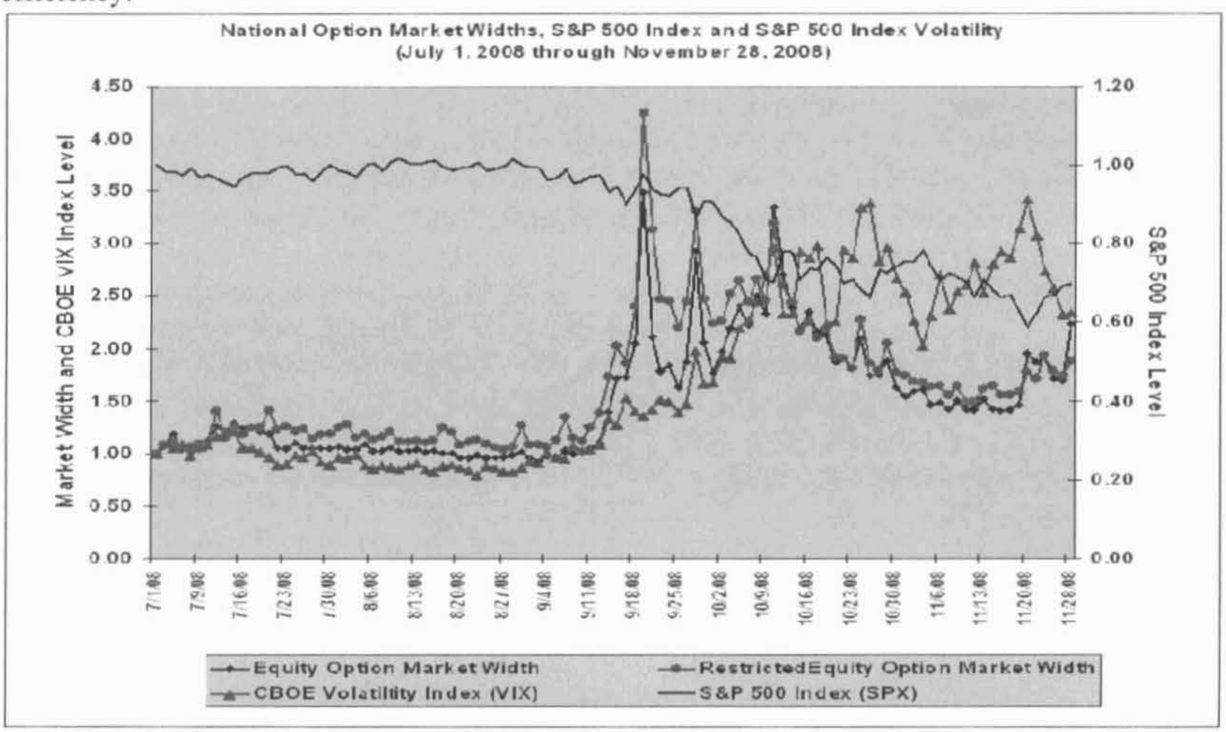
stock down. There would be regulatory consequences for misusing the exemption for speculative purposes. Moreover, it is highly unlikely that options market makers will engage in speculative stock trading, because they risk violating margin and net capital regulations, or the imposition of additional, onerous requirements.

- ***Options market makers have no incentive to force the price of a stock lower.*** Options market makers assume stock positions to hedge the options in which they make markets in an effort to remain market neutral and minimize risk. Because an exemption would be limited to bona fide hedging activity (not speculative activity), any gains from a short stock sale would be offset by exposure in the options, leaving an options market maker with no motive to engage in abusive short selling that a price test would be intended to pre-empt.

- ***The absence of an options market maker hedge exemption would impair fair and orderly markets.*** Allowing for a hedge exemption would assist options market makers in their ability to continuously disseminate two-sided options markets with reasonable widths and sizes. If an options market maker is not able to efficiently hedge, he would have no choice but to increase the options premium and widen options quote spreads to cover the hedging risk and increased costs. This increased cost would be compounded against already increased lending rates and other costs associated with maintaining a hedge in light of recent changes that heighten delivery requirements under Rule 204T. These increased risks and costs dampen liquidity and stability in the marketplace at a time when we need to encourage it.

Between July 1, 2008 and November 28, 2008, the financial markets underwent their most significant periods of stress in decades. The average daily equity option market widths (*i.e.*, the spread between the bid and the ask for multiply-listed equity options classes across the national equity option marketplace) showed a measurable increase as the market turmoil ensued. Most notably, however, is that these option market widths suddenly and dramatically increased in September 2008 as the news of impending emergency short sale orders were received by the marketplace. It was unclear initially as to whether and what extent options market makers would receive an exemption from the impending restrictions. With the normal hedging capability necessary to conduct their business under a potential threat, options market makers had to significantly reduce their exposure by increasing market widths substantially to compensate for the inability or perceived inability to effectively execute a hedge. Even more telling, in early October 2008, when the emergency short selling ban ended and the market began to receive news that the ban would not be further extended or reinstated, those same option market widths decreased to a still elevated but much less severe level, even though the broad marketplace continued its sell off, the S&P 500 index (SPX) continued to decline and the level of market volatility - as measured by the CBOE S&P 500 Market Volatility Index (VIX) - continued to increase.

In order to illustrate the unprecedented and dramatic effects on options market prices that came about as a result of the short sale restrictions instituted in the fall of 2008, the chart below shows national equity option market widths, in options classes overlying financial stocks that were subject to the September short sale ban and all other optionable securities, as well as the S&P 500 equity index and volatility index levels, all indexed to 1.0 as of July 1, 2008. As the market turmoil continued into September 2008, the data clearly shows that equity options market width, in those classes overlying restricted financial stocks and all other stocks, remained at a stable but moderately elevated spread until mid-September 2008, as would be expected in a period of increased market volatility. On September 18, when the initial news of the first sweeping short-sale restrictions was first incorporated into the market, options market makers were left suddenly uncertain as to whether they would be able to establish new hedging transactions or even maintain existing short stock positions, and were forced to significantly reduce the potential impact of these restrictions by increasing equity option market widths substantially. By the close of business on September 18, the indexed levels of equity option market widths overlying non-restricted and restricted stocks had risen to 2.05 and 2.40, respectively, from 1.40 and 1.74 at the start of the week, an increase of over 40% in each case. By September 19, those same levels had reached levels of 3.48 and 4.24 as options market makers could no longer assume the ability to establish and maintain hedges as it was initially unclear whether they would have an exemption from the short sale ban. Once the first signs of an exemption for options market makers were announced and incorporated into the market on September 22, those same levels began to fall, reaching 1.78 and 2.47 on September 23. As the short sale ban expired on October 8, the respective indexed levels stabilized to 2.49 and 2.66. By October 20, with Congress's enactment of economic stability measures and the understanding that no further short sale bans were imminent, those levels fell back to 2.13 and 2.18, continuing to decrease to 1.60 and 1.68 on November 3. As November progressed, the levels declined further, to 1.41 and 1.56 on November 17. It is telling that these market spreads continued to tighten even though, as clearly shown here, the S&P 500 index level declined 8% and the market volatility increased 13% during November, a clear measure that the ability for options market makers to establish and maintain necessary hedging transactions, including short sales, was the primary and overwhelming driver of equity option market widths. This is substantial and empirical evidence of the adverse effects short selling restrictions have on options market efficiency.



- ***Hedging stock market making risk is different than hedging options market making risk.*** There are distinct differences between the nature of options market making and market making in the underlying stock (though we also support an exemption for bona fide market making in the underlying stock). There are risks associated with trading options that are not present for stock specialists. 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. In addition, they usually will sell at their offer quote, which would not be inhibited by any price test restriction. A stock specialist also does not normally hedge with stock – instead the risk is built into the price of the stock. In the options markets, options market makers routinely take the other side of customer trades in an options transaction and must hedge the residual risk. They need immediacy in their hedges, which means selling at lower than the inside offer quote. As compared to a stock specialist whose trades are directional, any short sale trades by an options market maker are risk or market neutral. Options market makers also provide liquidity in multiple, sometimes hundreds of options series at any given time, subjecting them to substantial risk exposure that they need to be able to readily hedge. Managing this risk exposure can be very costly if impediments to hedging are imposed.

- ***An exemption is appropriate even though the former "uptick test" did not have a hedge exemption for options market makers.*** The need for an exemption is particularly critical, given that the proposal contemplates a short sale price restriction for options market makers in all NMS stocks including NYSE-listed securities and NASDAQ-listed securities, the latter of which were previously subject to an exemption from price restrictions on short sales for hedging by options market makers under NASD's short sale bid test.[29] The "uptick test" of former Rule 10a-1 adopted in 1938 was based on an auction/specialist market model where the bulk of trading took place at the primary listing market and a specialist could assure an execution at the next possible trading opportunity. The test also permitted the "tick" to be measured based on either the consolidated last sale or the particular market's last sale, the latter of which was applied by the primary, specialist-based markets like NYSE. The markets of 2009 are certainly not the same as the markets of 1938. Market developments, such as decimalization and penny pricing, the implementation of Regulation NMS, and the proliferation of execution venues and electronics, make today's equities markets more analogous to the dealer markets in which the NASD bid test operated than the centralized specialist market in which SEC Rule 10a-1 operated. As such, the bid test is the better alternative and, under the NASD version, it did include an options market maker hedge exemption that worked well for years. In any event, the equity markets today operate so differently than ten years ago, much less than 71 years ago, that the lack of an options market maker exemption under Rule 10a-1 is irrelevant as to whether such an exemption is

[29] CBOE had proposed on numerous occasions that the Commission also permit an options market maker hedge exemption from the short sale restrictions for exchange-listed securities under former SEC Rule 10a-1 (the "uptick test"). *See, e.g.,* letters from CBOE to Richard R. Lindsey, SEC (April 6, 1998); to Annette L. Nazareth, SEC (August 22, 2000); to Annette Nazareth, SEC (August 20, 2001); to Jonathan G. Katz, SEC (December 27, 1999)(regarding the SEC's short sale concept release); to Jonathan G. Katz, SEC (January 20, 2004)(regarding the SEC's Regulation SHO proposal). These requests became moot when the former Rule 10a-1 uptick test was repealed in 2007.

warranted now. Finally, there are now additional Regulation SHO requirements, such as Rules 204T, 10a-3T and 10b-21, which lessen any perceived need to limit options market maker short sales.

- ***The options market maker hedge exception operated effectively and as intended under the former NASD bid test.*** The modified uptick rule being considered is based on the former NASD bid test in effect for approximately 10 years prior to Regulation SHO. The exemption was developed after careful analysis and was designed to address the concern that the bid test would have an adverse impact on liquidity, options pricing, and options market makers' ability to hedge. The exemption allowed options market makers to provide liquidity and depth for listed options by allowing them to hedge without regard to the bid test restriction that was designed to prevent manipulative transactions. Additionally, the limited definitions and scope of the exemption meant that only highly regulated and surveilled options market makers could use the exemption. Use of this options market maker hedge exemption did not result in any cause for concern. We are aware of no significant regulatory matters involving abuse of the options market maker hedge exemption. In fact, the Commission found the options market maker hedge exemption for short sales in NASDAQ stocks to "facilitate transactions in securities and to protect investors and the public interest."[30] The reasons to support the inclusion of an options market maker hedge exemption are no less valid today. Moreover, there have been no reasons or empirical data provided to support the exclusion of the exemption from the proposed price tests. We recognize that the SEC did not include an options market maker hedge exemption when it originally proposed a uniform bid test under Regulation SHO in 2003 We thought that such an omission would have been a serious mistake, but as the proposed rule was not adopted, the issue became moot. Now with the SEC's current proposal for a bid test restriction, we urge the SEC to avoid that mistake. Indeed, today, the inside bid quote flickers so frequently, even more so than in the early 2000's when the SEC was first considering Regulation SHO, that it would be incredibly difficult for options market makers to hedge efficiently if subjected to a uniform bid test restriction.

- ***An options market maker exemption would not be a transmission mechanism that undermines the short sale restrictions.*** While the need to hedge is recognized as legitimate market activity, a concern has been raised that a non-exempted short seller might indirectly circumvent a price test restriction through use of the options markets (*i.e.,* to inappropriately drive the price of a stock downward, a market participant subject to a short sale restriction in an underlying stock could aggressively buy puts or sell calls with the expectation that the options market makers who are likely on the other side of the contract would use their short sale exemption to sell stock). This is a red herring issue that has been raised over the years, including as far back as when the NASD bid test was proposed. It is not, however, grounded in reality. There is no evidence that bear raids have been perpetrated through the use of puts and calls. Indeed, after studying the issue, NASD found no evidence that options market makers transferred selling pressure to the underlying stock market. The options market

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[30] *See* Securities Exchange Act Release Nos. 37492 (July 29, 1996), 61 FR 40693 (August 5, 1996) and 37917 (November 1, 1996), 61 FR 57934 (November 8, 1996).

maker hedge exemption performed well and the exchanges did not detect any abuses of the exemption by their members. Even if there would be limited instances where abuses might theoretically occur, that is no justification for failing to afford an exemption to those options market makers that would use it properly. The better approach would be to identify and punish violators, not punish the whole at the expense of market quality. With the heightened close-out requirements, transparency and regulatory oversight, the chance of this activity occurring and having any market impact has been further minimized. Given the level of transparency and access to information, and the ability of SROs and the SEC to enforce compliance, the need to allow options market makers to instantaneously hedge and the desire to maintain liquid, efficient markets, should outweigh the potential risk and burdens associated with not providing an exemption.

Part of the SEC's rationale for a price test restriction is that such a restriction would (1) prevent short selling at successive lower prices (or bids), thus eliminating short selling as a tool for driving the market down; and (2) prevent short sellers from accelerating a market decline by exhausting all bids at a price level. The events of the last 18 months, however, support our position that options market makers are not a vehicle for downward pressure on stocks. In particular, we have seen no evidence that hedging by options market makers had any role in the severe decline in stock prices, and especially in financial stocks during the emergency ban of short sales last year. The market sell off that occurred while the emergency short sale ban was in effect from September 19, 2008 to October 8, 2008 would have provided the single greatest opportunity for this theory to be validated. However, the data clearly shows that such a practice did not occur despite the fact that there was an options market hedge exemption to the short sale ban.

Additionally, there was no observable evidence of non-market makers attempting to indirectly utilize the options market maker hedge exemption to effect virtual short selling. This is evidenced by the following chart, which shows the percentage of total customer and firm option volume that either established an open position by buying puts from or selling calls to options market makers - the activity that would arguably trigger market makers' need to sell stock short. As is illustrated, this level of activity did not appreciably spike for any extended period during the subject time frame, and remained generally within the expected range (10-20%) of total customer and firm activity that is normal. Furthermore, there was no appreciable increase in the level of options market maker short positions in restricted financial stocks versus total options market maker short positions, which further evidences the absence of any abuse.

- ***Short stock positions of options market makers as a percentage of the total number of short sales is small and would not reach a level of short sales that could justify concerns about manipulation or downward pressure on stocks.*** The percentage of options market maker short sale activity as compared to other short sale is very small. For example, the short stock sale activity of CBOE options market makers (who are also options market makers on other options exchanges) was less than 3.0% of all short sale activity from July to November 2008, an insignificant level by any measure. 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.

- ***Regulatory oversight and surveillance will provide for early detection and appropriate discipline of violations of a hedge exemption provision and for general overall compliance with such a provision.*** Options market makers are already subject to several levels of scrutiny and oversight – by the SEC, the exchanges and other market participants. The trading of exchange-listed options is transparent, liquid, subject to OCC-counterparty risk protections, NMS-style trade-through requirements, firm quote and other SRO/SEC-based regulations and oversight. Moreover, under the former hedge exemption from the NASD short sale bid test, the options exchanges' surveillance procedures had provided that if an options market maker sells a NASDAQ stock based upon the former hedge exemption, he would be subject to appropriate regulatory or disciplinary action if not entitled to use the exemption. CBOE believes that similar procedures could be implemented if the exemption were granted.

- ***Options market makers do not have the ability to sell stock at the offer quotation.*** In the proposal, the SEC states that one reason for not including a market maker exemption (and presumably an options market maker hedge exemption) is that stock market makers can sell at the offer. Unlike stock market makers, options market makers do not have the ability to sell stock on the offer, but must place orders that generally result in a sale of stock at no greater than the disseminated bid. Having to enter an order at even one penny above the bid may seriously delay the options market maker's ability to hedge on a timely basis if at all. The price above the bid might never be an execution price.

- ***Precedent exists in other exemptions the Commission is considering.*** The SEC is supporting other exemptions that arise from needs very similar to those of the options market maker, such as the riskless principal exemption, the stock specialist facilitating public customer exemption, and certain arbitrage exemptions. These exemptions would not accommodate options market makers' hedging activity. However, they, as well as the former NASD bid test exemption, serve as strong precedent for granting an options market maker hedge exemption. Certainly, the options market maker's role in maintaining fair and orderly markets is no less important than that of an arbitrageur or specialist facilitator. Similar to riskless principal and arbitrage transactions, the options market maker's long market exposure in options offsets and neutralizes the market exposure of any short stock position, and therefore provide no opportunity to benefit from any decline in the price of the stock sold short.

- ***The Commission has recognized exemptions for market making in many contexts as it relates to short selling.*** Most recently, the Commission recognized exemptions for options market makers in relation to the July 2008 emergency order requiring a hard pre-borrow, the September 2008 emergency order banning short sales in certain financial securities, and as part of Rule 204T. In addition, there is an exemption from Rule 203's locate requirement. An exemption is also appropriate here. The rationales justifying these exemptions for options market makers are equally applicable in the context of the proposed price test alternatives. We also note that other countries have continually recognized the significance of having appropriate exemptions for market makers.

- ***An options market maker hedge exemption would be consistent with international short selling principles, as articulated by IOSCO.***[31] IOSCO has set forth four general principles for effective short sale regulation. The first three relate to (i) the importance of having a strict settlement discipline to minimize the potential destabilizing effect that certain types of short selling can cause; (ii) the merits of enhancing transparency on short selling, and (iii) the significance of having an effective compliance and enforcement system. Many of the steps that the Commission has already taken to regulate short selling, including adopting Rules 204T and 10a-3T, are consistent with these principles. Importantly, the fourth principle provides that short selling regulation should not stifle certain types of market activities that are critical for efficient market functioning and development. IOSCO indicated that activities following under this latter category may include "bona fide hedging, market making and arbitrage activities. As these activities generally provide benefits to the market and are unlikely to pose risks that will destabili[z]e the market, the [IOSCO] Technical Committee considers that short sale regulation should consider building in flexibility for these activities where appropriate."[32]

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[31] *See* note 8, *supra.*

[32] Id. at 19.

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CBOE thanks the SEC for this opportunity to present our views concerning the proposed rulemaking. We strongly urge the Commission to consider the adverse effects of imposing these changes on options market makers and the options marketplace. We are ready and willing to participate in discussions on the important issues raised in this letter and to provide any further information the Commission may need on our concerns over the lack of an options market maker exception to a short sale price test. Should you have any questions concerning CBOE's comments, please contact Jennifer Lamie at 312-786-7576.

Sincerely,

William J. Brodsky
Chairman & CEO

Edward J. Joyce
President & COO

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
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