



William J. Brodsky
Chairman and
Chief Executive Officer

Phone: 312-786-7001
Fax: 312-786-7407
brodsky@cboe.com

September 21, 2009

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

Re: File No. S7-08-09
Proposed Price Test Amendments to Regulation SHO
Supplemental Request for Comment

Dear Ms. Murphy:

The Chicago Board Options Exchange, Incorporated (“CBOE”) is submitting this letter in response to the Commission’s supplemental request for comment on an additional proposed short sale price test under Regulation SHO.¹ In the supplemental request, the Commission seeks further comment on an “alternative uptick test,” which would allow a short sale to be effected only at a price above the national best bid. We appreciate the time and consideration the Commission continues to dedicate toward evaluating whether re-implementation of a price test is appropriate and, if so, how it should be structured.

Short selling is a legitimate, longstanding, integral function in our markets. It enhances price discovery, mitigates market bubbles, increases liquidity, limits upward market manipulations and, importantly, facilitates hedging and other risk management activities. If the Commission would take the extraordinary step of adopting a price test, the approach should be narrowly tailored to target abusive short selling while not restraining legitimate activity (whether long or short, buying or selling), particularly activity that is critical for the maintenance of fair and orderly markets. Thus, any price test must be limited in scope and contain necessary exemptions for legitimate market making and risk management activity.

The Commission has proposed the alternative uptick test because, according to some market participants, it would be easier to comply with as it would not necessitate the sequencing of bids or last sales. On the other hand, the alternative uptick test would be a more restrictive price test than the proposed last sale test modeled after the former 10a-1 (the “uptick rule

¹ Securities Exchange Act Release No. 60509 (August 17, 2009), 74 FR 42033 (August 20, 2009); *see also* Securities Exchange Act Release No. 59748 (April 10, 2009), 74 FR 18042 (April 20, 2009).

alternative”) and the proposed last bid test modeled after the former NASD bid test (the “modified uptick alternative”) because it would preclude all short sales at a stock’s inside bid price, regardless of whether the stock’s price is increasing. This approach would effectively preclude the use of market orders to sell short and would make it far more difficult and costly to execute a short sale. While operational efficiencies are certainly a consideration in evaluating proposed rules, from a policy perspective we question the need to impose such harsh restrictions that will have huge implications for the market.

Particularly because it would be more restrictive, the alternative uptick test should first and foremost include exemptions for bona fide hedging by exchange-registered options market makers, if not for all legitimate hedging, stock and convertible market making, and arbitrage transactions. As discussed in our letter of June 19, 2009 the overriding concern we have is the crippling impact any price test restriction would have on the options markets and the legitimate trading activity of options market makers.² The options marketplace is used on a daily basis 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. To enable investors to have the capability to manage risk, options market makers must have the ability to hedge the risks they assume in an efficient manner. Without an options market maker hedge exemption, the proposed price tests would significantly impede the ability of options market makers to hedge and to manage the risks incurred in the course of performing bona fide market making obligations. Specifically, options market makers would be forced to post short stock sales above the bid and wait for buy-side interest to change to receive an execution, frustrating their ability to immediately execute stock transactions to dynamically hedge their options risk exposure and making it far more expensive to hedge their options market making positions. The result would be a serious deterioration in options market quality, with less liquidity and wider bid/ask spreads. Neither of these outcomes is consistent with the desire to stabilize markets and restore investor confidence.³

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. An exemption could be modeled after the options market maker hedge exemption that was included in the former NASD bid test, which was in place for nearly 10 years prior to Regulation SHO. Under that exemption, an NASD member could execute a short sale for the account of an equity or index options market maker so long as the short sale was an exempt

² Letter from William J. Brodsky and Edward J. Joyce, CBOE, to Elizabeth M. Murphy, Commission (June 19, 2009).

³ Indeed, when considering the principles of short sale regulation, the International Organization of Securities Commissions (“IOSCO”) has indicated 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 destabiliz[e] the market, the [IOSCO] Technical Committee considers that short sale regulation should consider building in flexibility for these activities where appropriate.” See Regulation of Short Selling, Consultation Report by the IOSCO Technical Committee (March 23, 2009).

hedge transaction and the options market maker was registered with a qualified options exchange as a qualified options market maker in an eligible options class.⁴

We cannot emphasize enough the importance of having an options market maker hedge exemption to ensure the fair and orderly operation of the options markets. As discussed in more detail in our June 19 letter, the options markets are a vital risk management tool for public investors and serve to reduce volatility in underlying markets. To enable investors to have the capability to manage risk, the listed options market needs to have market makers willing to take the other side of their trades and contribute capital to maintain liquid markets in the options underlying these stocks. To perform their important market function, options market makers must have the ability to hedge the risks they assume, to do so in an efficient manner, and at a minimal cost. 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.

If the alternative price test (or any 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 22, 2009 comment letter.⁵

We appreciate the intense public interest in the role of short selling in our markets. To be clear, CBOE is against abusive short selling activity - such as short selling used in conjunction with insider trading and short selling accompanied by false rumors designed to encourage others to sell - and we support vigorous regulation and enforcement against this sort of manipulative behavior. However, we believe the existing regulatory and enforcement framework of Regulation SHO can effectively detect and deter abusive short selling activity.

Over the last year, the Commission has implemented changes to enhance the delivery and settlement process (further decreasing the potential for abusive naked short sale activity), increase transparency around short sales, and create a special anti-fraud rule specifically designed to address potentially abusive naked short sales. The Commission should satisfy itself that these changes are operating in the full spirit of Regulation SHO and its existing regulatory, compliance and enforcement framework, and should avoid imposing direct restrictions on short sale activity. The Commission should also strongly consider how its regulatory proposals align with those being contemplated internationally. Rather than directly constraining short sales, overseas regulators appear to be focusing on the integrity of the settlement process, the merits of enhancing transparency, and the effectiveness of compliance and enforcement systems. Many of the steps that the Commission has already taken are consistent with these principles.

⁴ It is important to note that FSA has carved out an exemption for market makers, including options market makers, from their restrictions on short sales.

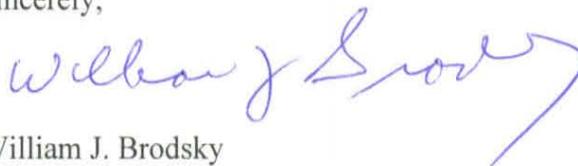
⁵ We are also concerned that two months will not be sufficient to implement changes that necessitate an industry-coordinated effort. With any alternative, the exchanges and the securities information processor need to develop, program, test and launch the operational, administrative and compliance-related changes.

In conclusion, we seriously question the need to adopt restrictive short sale price tests. If any such test is adopted, it is imperative that an exemption for bona fide hedging by options market makers be included. Adopting the new alternative uptick test without an options market maker exemption would have disastrous consequences for the quality of the options markets. We sincerely believe that if the Commission were to take such action it would have a draconian effect on the options markets.

* * * * *

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

Sincerely,



William J. Brodsky
Chairman & CEO

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