



Regulatory Circular RG06-14

Date: February 3, 2006

To: Members and Member Organizations

From: Division of Regulatory Services

Subject: Regulation SHO (Short Sales)

- Short Selling of Threshold Securities by Options Market-Makers

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The purpose of this Regulatory Circular is to address how Regulation SHO is interpreted as applying to options market-makers, including designated primary market-makers ("DPM"), when the security underlying the options in which they make markets is, or becomes, a threshold security, and in particular, the consequences of hedging with the underlying security when it is a threshold security. A question and answer format is used to address the primary issues. The answers were developed based on consultations with staff of the Securities and Exchange Commission ("SEC"). Nonetheless, the information provided below represents the views of the Exchange and should not be relied upon as a substitute for Regulation SHO or guidance provided by the SEC. For additional information on Regulation SHO and the SEC Division of Market Regulation's "Responses to Frequently Asked Questions Concerning Regulation SHO," please refer to the SEC's website located at <http://www.sec.gov/divisions/marketreg/mrfagregsho1204.htm>. SEC contact information is also available on this site. Further questions concerning Regulation SHO and this circular may be directed to Robert Gardner, (312) 786-7937, or James Adams, (312) 786-7718, in the Exchange's Department of Member Firm Regulation.

This Regulatory Circular supplements five previous Regulatory Circulars concerning Regulation SHO¹ (RG04-113, RG04-127, RG05-20, RG05-046 and RG05-127). These Regulatory Circulars may be found on the CBOE website at:

<http://www.cboe.org/publish/RegCir/RG04-113.pdf>
<http://www.cboe.org/publish/RegCir/RG04-127.pdf>
<http://www.cboe.org/publish/RegCir/RG05-020.pdf>
<http://www.cboe.org/publish/RegCir/RG05-046.pdf>
<http://www.cboe.org/publish/RegCir/RG05-127.pdf>

¹ Reg. SHO is described in Exchange Act Release No. 34-50103 (July 28, 2004), 69 FR 48008 (August 6, 2004). An online copy can be found at: www.sec.gov/rules/final/34-50103.htm.

KEY POINTS

When determining to hedge with a threshold security, a market-maker should keep the following points in mind.

- A fail to deliver occurs when the clearing firm has no stock, and is unable to obtain (e.g., borrow) stock, to deliver against a short seller's transaction.
- Regulation SHO limits the extent to which fails to deliver on the short sale of a threshold security may occur. As a consequence, market-makers in the options overlying a threshold security face uncertainty as to whether, going forward, they will be able to establish or maintain short positions in the underlying stock for hedging purposes as necessary to fulfill market-making obligations. This is because there can come a point in time in the case of a threshold security, generally a "hard-to-borrow" stock, when a participant of a registered clearing organization (i.e., a clearing firm) will be required to close-out a prior short sale fail to deliver, and pre-borrow stock to effect new short sales until that fail to deliver is closed-out.
- Regulation SHO defines a "threshold security" as any equity security where for five (5) consecutive settlement days 1) there are aggregate fails to deliver at a registered clearing agency of 10,000 shares or more; 2) the level of fails is equal to at least one-half of one percent of the issuer's total shares outstanding; and 3) the security is included on a list published by a self-regulatory organization.
- When the clearing firm has a fail to deliver position on a short sale of a threshold security, and the fail persists for thirteen settlement days, Regulation SHO requires immediate close-out of the short position, by purchasing securities of like kind and quantity. Beginning on the fourteenth consecutive settlement day, if a fail to deliver that has persisted for 13 consecutive settlement days is not closed-out, new short sales in the threshold security may not be effected unless the security has been pre-borrowed.
- Regulation SHO provides one limited exception for options market-makers. A failure to deliver on a short sale of a threshold security is not subject to the buy-in requirement, or the pre-borrow requirement, if the short sale was effected to hedge, or to adjust a hedge on, option positions that were created prior to the time the security became a threshold security.
- Options market-makers must be able to substantiate (through adequate documentation) that any short sale fails to deliver in a threshold security that are not closed out as required under Regulation SHO were, in fact, effected to hedge, or to adjust a hedge on, option positions that were created prior to the time the security became a threshold security.

DISCUSSION

Frequently asked questions concerning short sales of threshold securities by options market-makers, and responses, are given below.

Question 1

If a short sale in a threshold security is effected by an options market-maker to establish or maintain a hedge on option positions that were created before the underlying security became a threshold security, and the option positions are subsequently liquidated or expire, does the short position in the underlying security that was hedging the option positions continue to be exempt from the fail to deliver close-out requirement?

Answer

Yes. Pursuant to Regulation SHO, the short sale of a threshold security by an options market-maker is exempt from the buy-in requirement if the short sale was effected to establish or maintain a hedge on option positions that were created before the underlying security became a threshold security. The options market-maker exclusion from the close-out requirement does not terminate upon liquidation or expiration of the option positions. A residual short position in a threshold security, provided it originated from a short sale that was effected to establish or maintain a hedge on option positions that were created before the underlying security became a threshold security, may continue to be carried without regard to the fail to deliver close-out requirement. However, options market-makers must be able to substantiate that such short positions, if not closed-out, previously hedged option positions that were created before the security became a threshold security.

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Question 2

If an options market-maker's fail to deliver on a short sale is excluded from the close-out requirement because the short sale was effected to establish or maintain a hedge on option positions that were created before the underlying security became a threshold security, are further short sales by the options market-maker excluded from the pre-borrow requirement of Regulation SHO?

Answer

In the case where an options market-maker's existing fail to deliver is exempt from the close-out requirement, the pre-borrow requirement of Regulation SHO [Section 203(b)(3)(iii)] does not apply to further short sales. Please refer to Regulation SHO, Section 203(b)(3)(i), for further detail.

In the case of a short sale fail to deliver position that has persisted for 13 consecutive business days and was not effected to establish or maintain a hedge on option positions that were created before the underlying security became a threshold security, the pre-borrow requirement applies.

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Question 3

If the security underlying a class of options becomes a threshold security, can an options market-maker compute and set a maximum share amount that could be sold short going forward and trust that an aggregate short stock position less than or equal to that amount will be deemed a hedge of option positions created before the underlying security became a threshold security, and, therefore, not subject the close-out and pre-borrow requirements?

Answer:

No.

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Question 4

If an options market-maker's fail to deliver in a threshold security that has persisted for 13 consecutive settlement days is closed-out in conformance with Regulation SHO, can the options market-maker, on the same day, immediately following execution of the close-out, effect a new short sale in the same threshold security without pre-borrowing?

Answer

No. SEC staff has taken the position that the fail to deliver has not been closed-out if a new short sale is effected without a pre-borrow on the same day immediately following the close-out. SEC staff's position is based on its response to Question No. 5.7 of its "Responses to Frequently Asked Questions Concerning Regulation SHO." This document can be found at the following website address:

www.sec.gov/divisions/marketreg/mrfagregsho1204.htm

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Question 5

Are short positions in a threshold security that result from the exercise of a long put option or assignment of a short call option subject to the close-out requirement if a fail to deliver persists for 13 consecutive settlement days?

Answer

Yes. Any fail to deliver in a threshold security that persists for 13 consecutive settlement days is subject to the close-out requirement under Regulation SHO. There are no exceptions for fails to deliver that are the result of option exercises or assignments.

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Question 6

If the security underlying options is a threshold security, and an options market-maker is unable to fulfill market-making obligations because short positions in the underlying security cannot be maintained and / or established as necessary to hedge due to the constraints of the close-out and pre-borrow requirements, can an options market-maker sell the underlying security short to accommodate incoming closing orders only, and not be subject to the close-out requirement?

Answer

No.

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Question 7

If an options market-maker has a short, fail to deliver position in a threshold security that is not subject to the close-out requirement because it was effected to establish or maintain a hedge on option positions that were created before the underlying security became a threshold security, can the market-maker,

intra-day, close-out a portion of the short stock position and then sell short the same number of shares without becoming subject to the close-out requirement for the short sale?

Answer

Yes, provided the short sale is effected to maintain a hedge on option positions that were created before the underlying security became a threshold security. The short sale would not be subject to the close-out requirement because there was no net change (increase) in the short, fail to deliver position. The close-out requirements are determined by the end of day net position reported in the continuous net settlement ("CNS") system.

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Question 8

If an options market-maker has a short, fail to deliver position in a threshold security that is not subject to the close-out requirement because it was effected to establish or maintain a hedge on option positions that were created before the underlying security became a threshold security, can the market-maker, intra-day, sell additional shares short and then buy-in the same number of shares without eventually being subject to the close-out and pre-borrow requirements as a result of the intra-day short position?

Answer

Yes, the short sale would not be subject to the eventual close-out or pre-borrow requirement because there was no net change (increase) in the short, fail to deliver position. The close-out requirements are determined by the end of day net position reported in the continuous net settlement ("CNS") system.

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Question 9

If an options market-maker is long puts that hedge short puts and/or long calls and, to fulfill market-making obligations, the market-maker sells some or all of the long puts to accommodate incoming buy orders, can the market-maker sell short the underlying security when it is a threshold security to hedge option positions that were created **after** the underlying security became a threshold security and not be subject to the close-out requirement?

Answer

No.

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Question 10

A participant of a registered clearing organization (i.e., a clearing member) clears and carries accounts of options market-makers. The participant has a fail to deliver in a threshold security that has persisted for 13 consecutive settlement days. The participant determines that the trading activities of particular market-maker accounts it clears caused a portion of this fail to deliver position. Can the participant allocate responsibility for the close-out of the fail to deliver position that is attributable to particular market-makers to those market-makers?

Answer

Regulation SHO applies to all registered broker-dealers. As registered broker-dealers, options market-makers are within the scope of Regulation SHO and are responsible for compliance. Regulation SHO permits a participant of a registered clearing organization to allocate a fail to deliver to another registered broker-dealer for which it clears trades or for which it is responsible for settlement, based on such registered broker-dealer's short position. If a participant so allocates a fail to deliver position, the requirement to close it out applies to the registered broker-dealer to which it was allocated, and not to the participant. Thus, a market-maker that has been allocated the responsibility to close-out a fail to deliver position by the clearing firm is required under Regulation SHO to effect the close-out. If an options market-maker determines that close-out of a fail to deliver position allocated to it by the clearing firm is not required because the fail relates to a short sale that was effected to establish or maintain a hedge on option positions that were created before the security became a threshold security, the market-maker must document such determination and retain all relevant records.

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