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February 13, 2004

Mr. Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Re: ***Proposed Regulation SHO***
File No. S7-23-03

Dear Mr. Katz:

The Specialist Association ("Association") of the New York Stock Exchange ("NYSE") is pleased to respond to the request of the Securities and Exchange Commission ("Commission") for comments on proposed Regulation SHO ("Regulation SHO") in Release No. 34-48709 (October 28, 2003), 68 FR 62972 (November 6, 2003) ("Release"). Regulation SHO would make fundamental changes in the Commission's existing scheme of short sale regulation, consisting of Rules 3b-3, 10a-1 and 10a-2 under the Securities Exchange Act of 1934 ("Exchange Act"), and replace the short sale rule promulgated by the National Association of Securities Dealers ("NASD"), Rule 3350. Regulation SHO also contemplates the conduct of a two-year experiment that would permit short selling of selected stocks, including stocks listed on the NYSE, free of the uniform short sale price restriction contemplated by Regulation SHO.

Below we describe the basic features of Regulation SHO and some of the material differences between Regulation SHO and the existing rules that govern short selling. We then present our comments on various aspects of Regulation SHO, particularly those that would affect trading in NYSE-listed stocks and the operations of NYSE specialists. As specialists at the heart of the price discovery process on the NYSE, we believe that the members of the Association bring to bear an especially informed perspective on the dangers of unregulated short selling and the likely effects of the changes that the Commission proposes. In formulating these comments, our members have been motivated by concern with respect to their continuing responsibilities for maintaining fair and orderly markets in the NYSE-listed stocks in which they specialize and how the Commission's proposal would affect their ability to carry out those responsibilities.

We are grateful for the opportunity to submit our views after January 5, 2004, the cut-off date originally established for comments on the Release.

Regulation SHO.

Rule 200. Proposed Rule 200 would modify the existing definition in Rule 3b-3 of what constitutes a "short sale." The principal change would be to require, in the case of "long" positions currently deemed to be held by a party to a binding contract to purchase securities, that such contracts must specify a fixed price for the securities to be acquired (in addition to a fixed amount), and must provide for present delivery. Past staff interpretations with respect to liquidation of index arbitrage positions, positions underlying securities futures contracts, and the use of so-called aggregation units within large firms for purposes of calculating the firm's "net long" positions would be confirmed.

Rule 201. Proposed Rule 201 would impose a new uniform bid test ("Commission bid test") on short sales of all national market system securities, as defined in Rule 11Aa2-1 under the Exchange Act, in place of the Rule 10a-1 last sale "tick" test that governs short sales of listed securities and the bid test prescribed by NASD Rule 3350 in the case of Nasdaq national market system securities ("Nasdaq NM securities"). The Commission bid test would prohibit short sales of such securities at a price less than one cent above the consolidated best bid displayed in a consolidated quotation system, as the term "best bid" is defined in Rule 11Ac1-5(a)(7) of the Exchange Act.

Today, the Rule 10a-1 tick test bars short sales of listed securities at a price less than the last preceding different price, or equal to the last price if such price is less than the most recent different price. That test applies to short sales of listed securities included in the consolidated transaction reporting system ("CTA securities") wherever effected and to listed securities not included in that system that are effected on an exchange. It does not apply, however, to over-the-counter ("OTC") short sales of non-CTA securities.[1] The tick test for CTA securities operates by reference to the last sale price reported to the consolidated transaction reporting system unless, in the case of an exchange, the exchange has elected to use its own transaction prices as the reference point. The tick test for non-CTA listed securities operates instead by reference to the price at which the last transaction in the security to be sold short was effected on the exchange on which the short sale takes place. Rule 10a-1 contains narrow exceptions for short sales effected under various specific circumstances. These do not include general exceptions for short sales by specialists or market makers or for hedging short sales by options market makers of securities underlying standardized options.

NASD Rule 3350 prohibits short sales of Nasdaq NM securities at a price equal to or less than the best bid in Nasdaq if that bid is lower than the last preceding different best bid, but only

[1] Most non-CTA listed securities, we believe, are listed and traded only on a single exchange, but, of course, can be traded OTC at any time.

when such short sales are effected OTC. NASD Rule 3350 does not apply to short sales of such securities on exchanges that trade them pursuant to unlisted trading privileges. NASD Rule 3350 contains exceptions modeled on those contained in Rule 10a-1 for listed securities, but also excepts short sales by market makers in the securities sold short (provided that the short sale occurs in the course of "bona fide market making," as defined by the NASD) and hedging short sales by options exchange market makers in Nasdaq NM securities underlying standardized options (so long as the short sale meets the NASD's definition of an "exempt hedge transaction").

Unlike current price restrictions on short sales of listed and Nasdaq NM securities, the Commission bid test would bar short sales at the best bid price in both falling and rising markets. Further, unlike Rule 10a-1, where an exchange can elect to use the price of the last transaction effected on its own market rather than the last sale reported by any market to the consolidated transaction reporting system as the reference point for permissible short sales, proposed Rule 201 would not permit an exchange to elect to use its own price for that purpose.

Proposed Rule 201 would continue, in modified form, most of the exceptions now included in Rule 10a-1. Some would be eliminated as unnecessary or inappropriate in a short sale environment characterized by decimal trading and the Commission bid test. In addition, certain interpretive positions taken by the staff under Rule 10a-1 would be added as new exceptions.

Finally, proposed Rule 201 would modify and replace the current order marking requirements of Rule 10a-2 under the Exchange Act.

Rule 202(T). Proposed Rule 202(T) contemplates a two-year experiment in 300 stocks, some listed (where short selling is now covered by Rule 10a-1) and others not (where short selling is now governed by NASD Rule 3350). During the experiment, the stocks chosen for inclusion could be sold short free of the new price constraint contemplated by the Commission bid test. The experiment has yet to be defined in any detail. The Commission states, however, that it is considering including about one-third of the stocks now included in the Russell 1000 index, and that it expects to create two samples for study that "should be approximately similar in average market value and average volume."[2] Further, the Commission says that "[w]e hope that both samples would have similar short interest and similar expected volatility."[3] The Commission anticipates that the experiment will help the Commission determine whether short sale price regulation is necessary for actively traded securities.

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[2] Release at 62983.

[3] Id. at n. 101.

Rule 203. To combat "naked" short selling, which the Commission has concluded can lead to inappropriately large and continuing aggregate "fail" positions at clearing agencies, proposed Rule 203 would establish new Commission borrowing and delivery requirements in connection with short sales of any equity security ("Commission locate requirement"). The Commission locate requirement would replace somewhat similar requirements now imposed by the NYSE (in Rule 440C.10) and the NASD (in Rule 3370). Specialists and market makers would be exempt from the Commission locate requirement, but only to the extent that they engage in "bona fide market making," as defined in the rule.

In the event "fails" in any equity security at any registered clearing agency surpass 10,000 shares (if that amount is equal to at least one-half of one percent of the issue's outstanding shares), proposed Rule 203 would prohibit subsequent short sales of that security for any account that fails to deliver within two days. This prohibition would not apply if the seller has "pre-borrowed" securities for delivery, or has entered into a bona fide arrangement to borrow them, and delivers them on the delivery date ("Commission pre-borrowing requirement"). Specialists and market makers would not be exempt from the Commission pre-borrowing requirement.

Comments.

General Observations. We have long agreed with the Commission that short sale regulation has a valid and important purpose – to prevent manipulative or demoralizing short selling that can panic existing holders of a security into selling, thereby creating unwarranted price declines in what may be short-lived sell-offs and that generate increased and undesirable volatility in what otherwise would be fair and orderly markets.[4] We think that the Commission's scheme of short sale regulation (Rules 3b-3, 10a-1, and 10a-2 under the Exchange Act) has performed very well in the markets for listed securities in carrying out that purpose. We are less certain that the same can be said for NASD Rule 3350. We believe that Regulation SHO, which we propose below should be amended to apply only in declining markets, would provide an effective means of achieving that purpose in the markets for Nasdaq NM securities.

While we are primarily concerned about the short selling of NYSE-listed stocks in which we specialize, we agree in principal with and are in favor of extending Commission short sale regulation to Nasdaq NM securities because we think that ineffective regulation of short selling in any United States market can threaten investor confidence in the markets as a whole. We believe that subjecting short selling in all markets for Nasdaq NM securities to meaningful,

[4] See, e.g., letter from Robert W. Seijas and Joel M. Surnamer, Co-Presidents, The Specialist Association, to Jonathan G. Katz, Secretary, Commission, dated January 14, 2000, concerning Release No. 34-42037 (October 20, 1999).

comprehensive short sale regulation will improve and help stabilize those markets, thereby better protecting the interests of all investors.

It is not apparent to us why the Commission believes it is necessary to change the existing basis for regulating short sales of listed securities as part of a short sale reform that would properly regulate short selling in Nasdaq NM securities. We understand that there are those who would prefer to loosen all short sale constraints, especially those that effectively prevent unbridled short selling of listed stocks. They argue that our markets have become so efficient that short sale regulation is no longer necessary – as if there were some obvious connection between market efficiency and investor psychology – and that eliminating short sale restrictions would perfect them further by increasing liquidity. We disagree. From the Release, it appears that the Commission does as well. While Rule 10a-1 clearly affects the ability of short sellers to satisfy buying interest at lower prices in relation to the last sale (where that last sale is lower than the last preceding different sale price), opponents of the rule fail to take into account the likely effects of permitting them to put unchecked selling pressure at those prices on the fairness and orderliness of trading generally in times of market weakness. Market efficiency, by itself, is not enough to prevent market demoralizing short selling or investor panic.

NASD Rule 3350, compared to Rule 10a-1, does not appear to be a very effective restraint on inappropriate short selling. This is so because NASD Rule 3350 is undermined by its over-broad exceptions for market markers and by the NASD's inability to compel exchange markets to comply with it.[5] If short sale regulation for Nasdaq NM securities is needed, therefore, NASD Rule 3350 must be replaced. The Commission proposes to do this in Regulation SHO, which would apply to short selling of Nasdaq NM securities in all markets by all market participants. Recognition that Nasdaq NM securities short selling needs to be more comprehensively regulated, however, provides no basis for discarding the Rule 10a-1 tick test applicable now to short sales of listed stocks. Why not leave Rule 10a-1 basically as it is?

To achieve the purposes of short sale regulation, it is not necessary to use the same price restraining mechanism for all markets and all securities. The Commission should resist the

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[5] See, Release No. 34-34277 (June 29, 1994), 59 FR 34885 (July 7, 1999) ("NASD Short Sale Rule Order"), approving SR-NASD-92-12, proposing what has become Rule 3350. It was apparent that the NASD's reason for wanting to adopt a short sale rule in the first place had to do primarily if not exclusively with the desire to persuade managements of Nasdaq companies not to list on an exchange. See NASD Short Sale Rule Order at 34889. The argument was being made by at least one exchange seeking listings that the only way a company could obtain protection against price declines initiated or accelerated by short sellers was through Rule 10a-1, and that Rule 10a-1 did not apply to unlisted NM securities traded in Nasdaq. The NASD countered this sales pitch by proposing and obtaining Commission approval of the NASD's own short sale rule.

temptation to substitute consistency for practicality when dealing with the very differently structured markets for listed securities and those that trade Nasdaq NM securities. It is not necessary to dismantle what works well in this regard in the markets for listed securities simply because the same tool will not work as well in the markets for Nasdaq NM securities. Because it seems impractical to extend the Rule 10a-1 tick test to Nasdaq NM securities, the only feasible means of effectively constraining short sales of those securities is a broadly applicable bid test of the kind proposed by the Commission.[6] Retention of the existing last-sale based tick test for short sales of listed securities together with the Commission bid test for Nasdaq NM securities (revised as we suggest below) would provide effective barriers against market demoralizing short sales in both listed CTA securities, listed non-CTA securities,[7] and Nasdaq NM securities.[8]

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[6] The tick test would not work in the markets for Nasdaq NM securities, or would work only in a highly artificial way, because the OTC market remains essentially fragmented. See, e.g., NASD Petition for Commission Action Concerning the Trading of NASDAQ Listed Securities, letter to Mr. Jonathan G. Katz, Secretary, Commission, from Edward S. Knight, Executive Vice President and General Counsel, NASD, dated April 11, 2003. OTC transactions in Nasdaq NM securities are consummated OTC by numerous OTC market makers, commonly referred to by the Commission as "market centers," both within the NASD's SuperMontage and outside of it, on regional exchanges, and within ECNs, some of which have arranged to have their trades reported as regional exchange trades rather than as OTC trades. Further, last sales of Nasdaq NM securities do not have to be reported sooner than 90 seconds after a trade is completed. See NASD Rule 4632 and NASD IM-632. As a result, the sequence in which those trades and changes in the prices of NM securities occur is not and cannot be accurately reflected in the NASD's consolidated reporting system. In turn, this precludes rational application of the Rule 10a-1 tick test to Nasdaq NM securities. This is not the case for NYSE-listed securities, where the NYSE effects 90% of all trades in those securities, reports those trades for the most part almost immediately to the consolidated transaction reporting system, and where the sequence in which price changes occur is accurately captured by last sale reporting. NYSE Fact Book , www.nyse.com/about.

[7] As drafted, it appears that Regulation SHO would not apply at all to listed non-CTA securities (because they are not included in any consolidated quotation system) – an omission we suspect was inadvertent and that should be corrected.

[8] We observe that, as presently proposed, the NASD's application to register Nasdaq as an exchange would do nothing to integrate trading by its market markers in a way that would permit proper application of Rule 10a-1's tick test to short selling of Nasdaq NM securities on that new exchange. That theoretical concern, of course, provides no reason at all for changing the existing tick test in Rule 10a-1 with respect to listed securities. The Commission states in the Release that, if Nasdaq becomes registered as an exchange, Nasdaq securities would be listed securities and would be subject to Rule 10a-1. Release at 62979. This assumes that Nasdaq issuers would elect to register those securities under Section 12(b) of the Exchange Act, rather

[footnote continued]

We discuss below why we regard the Rule 10a-1 tick test and use of reported last sale prices to regulate short sales in the listed markets as superior to reliance on the displayed highest bid prices where it is possible to use the tick test. The markets for NYSE-listed securities are structured very differently and fragmented to a far lesser degree than the markets for Nasdaq NM securities. These differences, for purposes of short sale regulation, continue to matter.

We agree with the Commission that certain unhealthy trading practices, including abuse of so-called "married puts" and similar devices have proliferated and grown to an uncomfortable degree in recent years. Some of these devices are designed to thwart the short sale regulatory scheme by creating for hedge funds and other professional traders transitory "long" positions that can be sold free of existing price constraints on short selling. Regulation SHO and the companion interpretive release concerning "married puts," Release No. 34-48795 (November 17, 2003), seek to address and correct these problems. We think that it is important to do so to preserve the integrity of the Commission's regulatory controls on short selling and applaud the Commission for taking action in this regard.

There are certain aspects of Regulation SHO with which we do not agree and which we fear could have negative consequences that may not have been foreseen by the Commission. Most of our comments address those aspects of the proposal and explain the reasons for our concerns.

Experimental Removal Of Short Sale Price Constraints Is Likely To Have Adverse Effects. First and foremost, we regard the Commission's proposed experiment in removing price constraints on short sales of securities of publicly owned companies that now enjoy protection against uninhibited short selling as a bad idea. The experiment is likely to have unwarranted and unintended adverse effects on the markets for securities included in the experiment, operating to the detriment of the issuers of the included securities. For these reasons, we recommend against proceeding with the proposed experiment.

Managements of listed companies correctly believe that the protections afforded by existing Rule 10a-1 are an enormously important attribute of exchange listing. They will fear, legitimately, that removal of Rule 10a-1's price constraints on short selling of their companies' stocks for two years will undermine proper pricing, tend to discourage new decisions to invest, and weaken the resolve of current holders of their companies' stocks to refrain from selling them in times of market stress. Quite aside from these concerns, the experiment would unfairly

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than continue as Section 12(g) registrants, an unwarranted assumption. If they did not register under Section 12(b), Rule 10a-1 would not apply to short sales of those securities on the new Nasdaq exchange any more than it applies now to Nasdaq NM securities traded on exchanges pursuant to unlisted trading privileges.

disadvantage issuers included in the experiment compared to peer issuers whose securities remain subject to short sale price controls.

For example, assume that two listed stocks, A and B, generally viewed as economic equivalents (because both are in the same, well-established industry), are paired for purposes of the Commission's experiment – one, A, free of price controls on short selling, and the other, B, subject to Rule 10a-1 or the new Commission bid test. Assume further that news affecting both companies – *e.g.*, an industry-wide strike by a union – is announced. Can it be imagined that the price-depressing effect of such news on A will not be greater and more immediate than the effect on B? Note, too, that, under Rule 10a-1 (although not necessarily under the Commission bid test), short sellers can never establish a new low for B's stock on any day. They could and surely would do so for A's stock if such short sales in that stock were not constrained by a price restriction under the hypothetical circumstances described above.

Consider further the effect on the market for A's stock compared to B's stock if large blocks were offered for sale in response to the news released. The first few hundred shares of the stock offered for sale would eliminate both prevailing bids for the stock of A and B to the extent of the size associated with those bids. The specialists in A and B, as is typical in such situations, then would "spread" the quotes for those stocks, seeking the new equilibrium price for both.[9] This might well involve dropping the bid price for both temporarily by several dollars. Today, only long sellers can "hit" such a lowered bid. Indeed, short sellers in this circumstance would be precluded from selling at any price below the last preceding different sale price reported to the consolidated transaction reporting system – that is, anywhere between the new lowered bid and the last sale at the price originally bid at the time of the hypothetical news release. This would remain the case for B if Rule 10a-1 were to remain in place. Even under the proposed Commission bid test, short sellers would have to find a buyer at a penny above the new best bid for B (a price at which they also could sell under Rule 10a-1, but only if a long seller first determined to sell at the new lower bid, exhausted that bid, and then sold again at a price at least a penny lower). Short sellers, however, would be permitted to continue to hammer A's stock down by eliminating the new lower bid – and subsequent lower bids – and would have a very good chance of inducing long sellers to join in the selling. Under these circumstances, there would be an increased likelihood of a destabilizing sell imbalance sufficient to cause one or more trading halts in A's stock compared to the stock of B.

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[9] See, e.g., NYSE Floor Official Manual (June 2003), Chapter Two: The Specialist, Section VIII, Intra-Day Breakouts, at 38. For an example of circumstances where this technique is needed, see reports concerning destruction of the value of Corinthian Colleges' stock last December following massive selling that resulted from the mistaken entry of a large sell order, probably exacerbated by short sellers. See, e.g., letter from Edward Knight, Executive Vice President, Nasdaq, to Annette L. Nazareth, Director, Division of Market Regulation, Commission, dated December 8, 2003.

We would expect the decline in A's stock to be much more rapid and harder to moderate than would be the case for the stock of B. That slowing of the downward trend in B's stock would allow, among other things, time for other buyers to enter the market for B, tending to support its price. In contrast, the entry into the market for A's stock by new buyers would be deterred until stability at some lower price could be restored. In sum, we would expect that a new equilibrium price could be established for B much more rapidly than would be the case for A in these circumstances. Finding such an equilibrium price for both stocks as quickly as possible would be critically important in such a situation. Failure to do so would convey a message of instability and disorderly trading to investors.

For the foregoing reasons, we believe that an experiment in removing price constraints on short selling would be dangerous and unwise. We urge the Commission to reconsider and reject it by abandoning proposed Rule 202(T).

The Commission Bid Test Will Not Work As Well As The Existing Tick Test For Listed Stocks. As we noted above, we recommend against changing the existing Rule 10a-1 tick test for listed stocks to the proposed Commission bid test, as contemplated by proposed Rule 201. First, the Commission bid test would interfere inappropriately with short sales in rising markets. Second, we believe that (i) the existing tick test does a better job of preventing short sales in a falling market than can be expected of the Commission bid test; and (ii) the reference point for pricing short sales should remain the most recently "reported" price, or the most recent price at which a trade was "effected" on the electing exchange as is the case now under Rule 10a-1(a), rather than the price currently "displayed" in the consolidated system, as would be the case under proposed Rule 201. In particular, it would be inappropriate to compel participants in the NYSE market to rely on the best bid "displayed" in that system by another market as the reference point for permissible short sales on the NYSE rather than the best bid (or, better, last sale) on the NYSE itself. Finally, we are concerned that changing the Rule 10a-1 tick test to the Commission bid test (even if it is revised as we suggest it should be below) might have significant unexpected effects and consequences – always a risk when such a basic and long-standing trading rule is changed.

The Commission states in the Release that the Rule 10a-1 tick test was designed to allow relatively unrestricted short selling in an advancing market, prevent short selling at successively lower prices, and prevent short sellers from accelerating a declining market by exhausting all remaining bids at one price level, causing successively lower prices to be established by long sellers.[10] Later in the Release, the Commission says that it believes that the Commission bid test "would promote the fundamental goals of short sale regulation," and says that the new test would "facilitate relatively unrestricted short selling in an advancing market, because the short selling

[10] See Release at 62974.

reference price would move with the current interest in the market."[11] We acknowledge that the short selling reference price would "move with the current interest in the market," but the new Commission bid test would preclude short sales at the consolidated best bid even if that bid were to be above the last preceding different consolidated best bid. This abandons, for no articulated reason, the idea that relatively unrestricted short selling should be permitted in an advancing market.

The Commission does not propose an alternative to the Commission bid test, but asks for comment on a version of that bid test that would allow short selling at any price that is equal to or above the consolidated best bid if that bid is higher than the last preceding different consolidated best bid.[12] We agree with the idea that such short selling should be allowed and suggest that the Commission bid test be revised to preclude short selling at a price equal to or lower than the consolidated best bid whenever that best bid is below the last preceding different consolidated best bid ("revised Commission bid test"). We believe that the revised Commission bid test would improve upon the short sale price constraint now proposed and would conform more closely to the original and still valid idea that short selling in advancing markets should be relatively unrestricted. This is the rule that we believe should apply to short sales of Nasdaq NM securities. In the case of listed securities, however, the best result would be obtained by leaving in place the existing Rule 10a-1 tick test.

The revised Commission bid test that we propose, however, if applied to listed stocks, still would permit short sellers to establish a new lower price for such a stock on any day, something we regard as inappropriate given the purposes of short sale regulation. This cannot occur in listed stocks now without action by long sellers to establish such a new lower price. When a new lower price is established by a long seller, no one can sell short at that new lower price under Rule 10a-1 until an even lower price is subsequently established by the same or another long seller (because otherwise the short sale would occur on a prohibited "zero minus" tick).[13] It is this mechanism that has kept short sellers from driving listed stock prices down unaided by long sellers, who now must be the first to establish lower prices at which short sales can be effected lawfully. While the revised Commission bid test should operate to provide much

[11] Id. at 62980.

[12] Id.

[13] We note that decimalization, to some extent, has undermined this salutary effect by reducing the economic significance of a single tick and even more the significance of two ticks. A two tick change in price prior to the move from eighths to sixteenths and then to pennies meant a market movement of \$.25. Today such a move means only \$.02. We still believe, however, that the tick test is of great value in keeping short sellers from creating or taking undue advantage of stock price weakness or a downward trend in the price in a listed security.

more meaningful protection against improperly motivated or market demoralizing short selling in Nasdaq NM securities than now exists, it would not do so in the markets for listed stocks. The Rule 10a-1 tick test does a better job of that.

Even if amended to apply only in declining markets, the revised Commission bid test would interfere with fair and orderly trading in NYSE-listed stocks. It would tend to increase volatility in such trading because (i) the new rule would rely on the relatively artificial measure of what current securities prices are (represented by prices "displayed" in the consolidated system rather than prices "reported" to that system) to govern permissible prices for short sales, and (ii) the new rule, as noted above, would preclude market participants on the NYSE from relying on the NYSE's own current highest bid in a manner analogous to its current ability to rely on its own last sale price under Rule 10a-1. The problem with the new Commission bid test, even as we would revise it, is that trading activity on the NYSE floor often moves on very rapidly from prior price levels reflected in "displayed" bids, including the most recently displayed NYSE best bid.[14]

Prices for NYSE-listed stocks are discovered and created almost exclusively on the floor of the NYSE.[15] This crucible of price discovery operates primarily in response to orders, bids and offers (many of them ephemeral and taken or removed before they are reported and displayed) and indications of buying and selling interest made known on our floor, but usually not communicated elsewhere. While our specialists are aware of prices that occur in other

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[14] Knowledge of what is currently occurring on the NYSE floor is shared by every interested market participant on that floor even if that information is not known elsewhere until reports of such current activity are displayed in the consolidated transaction reporting and quote systems. This may be criticized as an imperfection in Rule 10a-1 that would be corrected by the Commission bid test (in its original form or as we recommend revising it), which would set the same price levels at the same time for all market participants, on-floor and off. That criticism, however, ignores the fact that, notwithstanding that differently situated market participants are able today for fleeting moments to sell short at the same time at different price levels under Rule 10a-1, that rule's whole purpose is to prevent market demoralizing short sales. This function is well served by Rule 10a-1's tick test notwithstanding that it does not always apply to all market participants in the same way at the same time. We do not believe that such momentary differences in Rule 10a-1's application favor or disfavor any segment of market participants and, therefore, that they are not harmful to the markets or market participants.

[15] We do not mean by this that a price is not "discovered" for an NYSE-listed stock, in some sense, any time a willing buyer and seller agree upon a price at which both are willing to transact regardless of where or when that agreement is reached. We do mean, however, that prices for NYSE stocks "discovered" elsewhere than on the NYSE are virtually always informed by and are derivative of the prices that eminate from the NYSE.

markets when they quote prices and sizes in their specialty stocks, the prime drivers of their activity are the limited price and other orders entrusted to them for execution and interest expressed by floor brokers as to their willingness to transact at particular prices in particular sizes. For purposes of the markets that specialists make on the floor of the NYSE, it is buying and selling interest expressed and transactions effected on the NYSE that matter.

In this regard, it should be remembered that the transaction and bid prices for NYSE-listed securities in markets other than the NYSE usually (not invariably, but usually) lag behind the transaction and bid prices established on the NYSE. Since bids and offers announced on the NYSE floor and transactions concluded on that floor become known to all interested market participants on the floor as they occur, subsequent trading activity on the NYSE responds immediately to what has just occurred there rather than to what is later "displayed" in the consolidated transaction reporting and quote systems about what happened earlier.

As the primary market in its own stocks, trades and price level changes on the NYSE can occur in very rapid sequence, outpacing the ability of reporting systems to capture and display them, perhaps not by much in most cases, but sufficiently to matter in times of stress on the NYSE floor. We think that this state of affairs was understood at the time Rule 10a-1 was amended in the 1970s to accommodate consolidated last sale reporting. It is why Rule 10a-1 speaks in terms of prices "reported " to the consolidated system rather than those "displayed" where the general rule articulated in paragraph (a) of Rule 10a-1 applies. Similarly, that amendment took these facts into account by allowing an exchange to elect to use its own last sale price – immediately and not just when "reported" to the consolidated system – rather than the consolidated last sale price as the reference point for permissible short sales on that exchange. Current Rule 10a-1(a)(2) allows NYSE specialists, within the price constraints of the tick test, to continue to operate as they do in carrying out their specialist functions properly in light of information generated and collected on the NYSE floor. The new Commission bid test, even as we have suggested it should be revised, would interfere with and negatively affect those operations.

The Commission also should take into account that the previous day's closing price on the NYSE controls the prices at which stock can be sold short in the opening the next morning. The revised Commission bid test would set that price level in the opening instead by reference to the last highest bid displayed in the consolidated quote system prior to the close of that system. Even if it were to become permissible for short sellers on the NYSE to use the NYSE last best bid, rather than the last consolidated best bid, as the reference point, the closing sale on the NYSE on the preceding day – which currently dictates the level at which short sales can be made in the next day's opening on the NYSE – often will differ from the price of that last bid. We are uncertain how either change would affect the openings on the NYSE. We are concerned, however, that such a change could introduce an artificial element into formulation of those opening prices, usually viewed as the most "important" price of the day. Uncertainty in this regard provides yet another reason for favoring retention of Rule 10a-1 over adoption of a revised Commission bid test for listed stocks.

Finally, the experience of our specialists is that displayed bids and offers for many NYSE-listed securities "flicker" in our decimal trading environment – that is, they change very, very rapidly. They believe that this occurs to a greater degree than changes occur in transaction prices. That is, notwithstanding the transition to decimal trading, "flickering last sales" have not become a problem whereas "flickering quotes" are widely recognized as problematic. This will impede and confuse those who must comply with proposed Rule 201, especially in the case of listed stocks. Such confusion does not exist today in connection with short selling under Rule 10a-1.

We have recommended that the Commission retain the existing Rule 10a-1 tick test for short sales of listed securities. If the Commission nevertheless decides to adopt the revised Commission bid test that we have proposed, we believe that Rule 201 must be further changed to mirror certain elements of existing Rule 10a-1. In particular, the Commission should modify the revised Commission bid test to permit participants in the NYSE's market to rely on the most recent best bid established on our floor in place of what will all too often be a stale measure of price represented by the best bid "displayed" in that system (whether by the NYSE or some other market). We emphasize again our conviction that the most recent price on the NYSE is the proper reference point for NYSE short sales effected on that exchange.

Proposed Rule 203 and Bona Fide Market Making. The Commission's effort to address the accumulation of large "fail" positions at clearing agencies resulting from so-called "naked" short selling is admirable and we believe that the proposed new Commission locate requirement is an appropriate way to do so. As the Commission realizes, it would be impossible, however, for specialists and market makers to comply with that requirement in the course of active market making. The Commission therefore has provided that the Commission locate requirement will not apply to short sales effected by them "in connection with bona fide market making activities."[16] We have no objection to articulation of this general standard as a precondition to reliance on the exception, but believe that NYSE specialists, in light of the affirmative and negative obligations to which they are subject under NYSE rules, should be deemed to satisfy that standard without further inquiry. As written, we disagree with and object to the interpretation of that standard stated in note 49 to the Release.[17]

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[16] We observe that the "bona fide market making" condition in proposed Rule 203 has its origins in NASD Rule 3350. We think that the reason why the NASD found it necessary to include that condition in its own rule was to prevent wholesale evasion of the rule by OTC market makers, who are subject to no meaningful affirmative or negative obligations (unlike NYSE specialists), in transactions effected by them having nothing to with their market making functions. We believe that there should be no such concern, with respect to the trading activity of NYSE specialists. Application of a mandatory and "bona fide market making test" to NYSE specialists, therefore, strikes us as inappropriate and unnecessary.

[17] See Release at 62977.

Note 49 states that the "bona fide market making" condition precedent to reliance on exemption "would exclude activity that is related to speculative short selling strategies or investment decisions of the broker-dealer or associated person and is disproportionate to the usual market making patterns or practices of the broker-dealer in that security." This gloss on "bona fide market making" is simply too vague. We do not believe that it would be construed uniformly and administered in a fair, objective manner. The conduct of NYSE specialists should not be judged by regulatory personnel by reference to what they believe, subjectively, constitutes a "speculative trading strategy" or "investment decision." Nor do we think such personnel should attempt to determine whether NYSE specialists' trading on any given day or series of days is "disproportionate" to their "usual market making patterns or practices" with respect to a particular security. As the Commission knows, the character and nature of the market and trading in most securities is always in a state of flux. Change is constant in the markets, and day to day NYSE specialists must change what they do to respond to numerous company-specific and external factors and collective assessments of their significance over which no particular investor or trader, including the NYSE specialist, has any control. Whatever the "normal" trading pattern for an NYSE specialist in XYZ might have been over the course of several prior weeks or months, that course of dealings may well be irrelevant to what the specialist is called upon to do today – and what the specialist does today may vary significantly from that specialist's past "pattern." That variance, of course, should never be viewed as an indication that the specialist is not engaged in bona fide market making.

The proposed standard for assessing "bona fide market making" should be revisited by the Commission. If it cannot be improved for purposes of proposed Rule 203, it should be abandoned. The Commission should acknowledge that the question whether buying or selling by a specialist or market maker is bona fide market making in a particular instance (instead of a disguise for speculation) can be answered only by applying an overall facts and circumstances analysis to the trading being examined. Generalizations of the kind stated in note 49 to the Release do not do this and fail to provide meaningful guidance to those who would have to comply with the Commission's rule and those charged with responsibility for enforcing it.

Specialists Should Be Exempted From The Pre-Borrowing Requirements For Large "Fail" Position Stocks. Adoption of Rule 203 as proposed would disrupt the NYSE market for listed securities unless its specialists are excepted from application of paragraph (b)(3)(i) of the rule. In this regard, the Commission should take into account that specialists on the NYSE are subject to meaningful affirmative obligations to make markets at all times (as well as negative obligations that restrict unnecessary and destabilizing trading by them). These affirmative obligations require them to make markets even when a listed security, for whatever reason, has become temporarily illiquid or when a significant imbalance exists between the buy and sell sides of the market for that security. Making markets under such circumstances necessarily entails the risk that, when a specialist goes short to satisfy demand and provide liquidity to buyers, the specialist may encounter unusual and sometimes insurmountable difficulty in obtaining securities to borrow and deliver against those short sales. Taking that risk and encountering that problem should not entail the further risk that the specialist will no longer be able to make a market in that security at all.

If a clearing agency's "fails" in a listed stock exceed the threshold contemplated by proposed Rule 203, something that can occur even though the specialist is not in a "fail" position and therefore has not contributed to the clearing agency's aggregate "fail" position, the specialist in that stock could be precluded by rule from effecting further short sales. Inability to sell short would end the specialists' ability to make a market in that stock notwithstanding their affirmative obligation to do so under NYSE rules. Specialists could escape from that dilemma only if they were able to satisfy the new Commission pre-borrowing requirement, and it is uncertain whether they could do so reliably in times of market stress.

Depriving the market of the liquidity provided by specialists in any NYSE listed stock strikes us as unthinkable. To do that would gravely harm the entire market for the security involved. To avoid that result, the Commission should reconsider the draconian nature of proposed Rule 203's effect on NYSE specialists. Even if the Commission continues to believe that it should put in place the Commission pre-borrowing requirement as a general matter, the Commission should exempt NYSE specialists from that requirement (just as market makers are exempt under NASD Rule 11830 and both specialists and market makers would be under the proposed Commission locate requirement). Without such an exemption, the Commission pre-borrowing requirement will present a continuing threat to the maintenance of fair and orderly markets in NYSE-listed securities.

ADR Pricing Should Be Kept In Line with the Prices of Underlying Shares. We believe that, in the case of ADRs, it should continue to be possible in the opening to bring United States prices in ADRs in-line with the prices for the underlying ordinary shares established in foreign markets without regard to the Commission bid test. Such action is necessary to preserve the proper pricing relationship between ADRs traded on the NYSE and the underlying ordinary shares. There is no conceivable reason for a difference in the price of ADRs from the price of the underlying ordinary shares (except perhaps currency differentials and miscellaneous small costs associated with ADRs). Since the prices for the underlying shares do and should control the prices of ADRs, we see no opportunity for short selling abuses in connection with ADR trading in the opening. Regulation SHO should recognize these facts by exempting ADR short sales in the opening at prices at or higher than parity with the underlying securities in the home market from the Commission bid test.

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If you have any questions concerning any part of our letter or would like to discuss with us any aspect of proposed Regulation SHO that we have not addressed, please contact me at (212) 589-0490.

Sincerely yours,

David Humphreville

cc: William H. Donaldson, Chairman
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