March 30, 2009

The Honorable Mary L. Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

RE: SEC Proposal on Short Sale Price Test

Dear Commissioner Schapiro:

Direct Edge Holdings LLC[1] ("Direct Edge") recognizes the challenging position that the Commission finds itself in as it actively weighs additional regulatory measures to combat abusive short selling. Short selling has become an emotionally and politically charged subject as abuses of short selling are easier to understand than the constructive reasons why a market participant sells stock that it does not own. Advocates for general, rules-based restrictions on short selling take for granted that the U.S. cash equity markets have continued to operate well during the recent period of extreme market volatility. In contrast, Direct Edge believes that the market is similar to an ecosystem where changes to the environment can have unintended consequences that can damage traders and investors alike. Any regulation which restricts the liquidity and price efficiency that a form of trading activity brings to the marketplace potentially diminishes the liquidity in that marketplace as a whole. Direct Edge believes that appropriate public policy requires targeting abusive conduct as opposed to discriminating against one type of market liquidity over another.

Direct Edge's perspectives on this issue focus on reforms that would have real impact while preserving the elements of liquidity, efficiency, transparency and fairness currently present in the marketplace. We believe that a *prudent and disciplined approach* is required when new regulation is implemented to ensure that benefits to these fundamental market building blocks exceed their costs (both financially and to the operation of our markets generally). This is why we support more vigorous enforcement of existing locate, borrow and delivery regulations as well as the enhancement of short interest disclosure. Given the delicate balance of these considerations, we are encouraged that the Commission will engage in a notice and comment period sufficient to ensure

[1] Direct Edge currently operates the third-largest stock market for the trading of U.S. equity securities, behind only NYSE Euronext and NASDAQ OMX. To date in March 2009, Direct Edge has handled over 2.1 billion shares per day through its trading systems, representing 17.3% of all U.S. stock trading. More information about Direct Edge is available at www.directedge.com.

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constructive discussion with impacted market participants respecting the various regulatory alternatives for surveilling, controlling and combating abusive short selling.

Advocates for the uptick rule question the rule's repeal and argue that it worked well enough for seventy years. Missing from these discussions is an acknowledgement that the Commission, after careful deliberation, determined that price restrictions were largely ineffective at dampening volatility in an electronic, fast-moving market and that regulation focusing on abusive conduct, specifically naked short selling, was a more effective and less costly instrument to regulate abusive short selling. As aptly put by NYSE Euronext in a letter filed with the Commission in 2007: "the potential risk to markets posed by short selling has been reduced through market efficiencies, effective surveillance, and rule-making – along with the continued threat of prosecution, under the general anti-fraud and anti-manipulation statutes of the federal securities laws, for those abusive short selling schemes that do occur - short sale price restrictions have become not only unnecessary, but also their continued maintenance will serve only to interfere with the mechanism of an efficient market."[2] Further, the Commission's targeting of naked short selling through the passage of stringent locate, borrow and delivery requirements, such as Rule 204T, have yielded impressive results to date by drastically reducing the incidence of failures to deliver. Interim final temporary rule, Rule 10a-3T and temporary Form SH (Form SH) requiring short sale disclosure by certain investment managers represented an important step in ensuring an appropriate level of transparency into short interest held by money managers. We are hopeful that a fully informed process respecting additional short sale regulation will appropriately account for both implementation costs, as well as the impact on market liquidity and pricing efficiency generally.

Others in the industry embrace a reinstatement or modified reinstatement, seemingly without conviction, on the grounds that the Commission needs to "make a statement" or "do something" to provide a psychological lift to the marketplace. For example, while the NYSE Euronext and Nasdaq OMX Group, Inc. have recently advocated for a modified uptick rule,[3] the chief executive officer of NYSE Euronext has publicly stated that he has no reason to believe that the uptick rule will have any impact on the way that the markets work[4] but supported it because it would "make people feel better" and it was

[2] NYSE Comments on Proposed Rule: Amendments to Regulation SHO and Rule 10a-1 (File No. S7-21-06), February 14, 2007, p. 1.

[3] In a letter to Mary Shapiro, dated March 24, 2009, NYSE Euronext, Nasdaq OMX Group, National Stock Exchange and the BATS Exchange proposed that when a stock falls by 10% or more during a single session, short selling could only be initiated at a price above the highest prevailing national bid by posting a quote for a short sale order priced above the national bid.

[4] Nina Mehta, "Niederauer and Greifeld Anticipate New Short-Sale Rule," Traders Magazine.com, October 31, 2008.

"the easiest way to quickly re-instill confidence."[5] While it is easy to be frustrated about the direction of the markets, we caution against formulating a regulatory response out of frustration. Moreover, we are concerned that the ineffectiveness or worse, harmful effects, of price restrictions at achieving their desired objectives risks undermining the U.S. equities markets and the agencies that regulate them.

Direct Edge does not believe that a so described "Modified Uptick Rule" is the proper form of short sale regulation because it would act as a broad-based restriction on the liquidity trading strategies of market participants and the liquidity created thereby. Such an approach would also distort market price action by creating more selling pressure in a rapidly falling market. The existence of short sale circuit breakers, or any trigger based on a market condition for that matter, could artificially increase selling pressure on stocks as their value approached the relevant price level, as sellers would have an incentive to engage in premature selling in anticipation of the restriction becoming active. Such a state would increase volatility and the potential for market manipulation, damaging investors, listed companies and traders alike.

We submit that the better objective for short sale regulation would be to enhance transparency and tighten enforcement against naked short selling and fraudulent conduct. Targeting identified conduct would enhance the benefits of the regulation and reduce costs, both in terms of implementation and marketplace impact. With fuller money-manager transparency to regulators of actual and synthetic short activity, such as credit default swaps,[6] and stringent regulation of locate, borrow and delivery requirements, abusive conduct can be surveilled, controlled and combated without disrupting the mechanics of an efficient, liquid market. We believe that such a framework, similar to that advocated by the Financial Services Authority in their recent discussion paper on the regulation of abusive short selling,[7] would be the most effective at empowering regulators to surveil, control and combat abusive short selling.

Too many advocates for the reinstatement of the uptick rule discount empirical evidence that such price restrictions will fail to accomplish their intended objectives and be detrimental to the healthy functioning of the marketplace. The Securities and Exchange Commission's empirical analysis,[8] conducted by its Office of Economic Analysis, was so compelling in support of the above that it led to the repeal of price restrictions in 2007. Among other things, the study found that "the percentage of time the market is in a downbid state *declines* when the bid test is removed, suggesting that downbids occur

[5] FOXBusiness News, Interview with Alexis Glick, November 21, 2008.

[6] *See also* Financial Services Authority, Discussion Paper, 09/01 at 5.60-5.62.

[7] *See generally* Financial Services Authority, Discussion Paper, 09/01

[8] Economic Analysis of the Short Sale Price Restrictions Under the Regulation SHO Pilot, Office of Economic Analysis, U.S. Securities and Exchange Commission (the "2007 Analysis").

more regularly when the bid test applies."[9] The study also found that there was no evidence of bear raids occurring more frequently with respect to those stocks that were subject to price restrictions as compared to those that were not.[10]

In more recent studies conducted by the Office of Economic Analysis, it was found that the recent steep declines in stocks were primarily the result of stockholders selling their equity interests, not short sellers, and again countered the notion that recent "bear raids" by short sellers brought down the market.[11] The study found that during the recent extreme declines, short sales were too small a portion of total stock sales to factor heavily in their drop and that short sales put less pressure on prices than other sales during periods of extreme negative returns.[12] We believe that the results of these studies are so powerful and relevant that they should be posted on the Commission's web site. Other private studies reach similar conclusions.[13]

It must also be noted that empirical evidence indicates that price restrictions will not provide the anticipated sustained lift to the marketplace[14] as these restrictions cannot alter the perception of value in the marketplace; they can only distort price signals and lead to a widening of bid ask spreads.

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[9] 2007 Analysis at p. 7.

[10] 2007 Analysis at p. 56 (Evidence of bear raids were tested in three ways: (i) relative frequency of large negative vs. large positive stock returns; (ii) large negative returns that are very quickly reversed, or a "negative price spike." (iii) the tendency for price movements to be reversed in subsequent periods. Further, the study did not find: (i) that short sale price restrictions reduced the short interest held in the market; (ii) any statistically significant differences in return for those stocks subject to price restrictions compared to those that were not; or (iii) any discernable effect of price restrictions on daily return volatility. (p. 6, 56) The study recognized other studies that found no increase in short selling on days that there were abnormally negative returns in the market.(p. 56))

[11] FoxBusiness.com, "Will The SEC Bring Back The Uptick Rule," March 13, 2009.

[12] Daniel Aromi and Cecilia Caglio, "Analysis of Short Selling Activity during the First Weeks of September 2008," December 16, 2008 (reproduced courtesy of FoxBusiness News).

13 Arturo Bris, "Short Selling Activity in Financial Stocks and the SEC July 15th Emergency Order," August 12, 2008 (the study focused on the nineteen firms that were the subject of the Commission's July 15th Executive Order requiring a pre-borrow to short named financial institutions. The study, which analyzed data for the months preceding the emergency order, found that the negative returns and significantly worse market quality of such securities could not be attributed to short selling activities.)

[14] Jeff Benjamin, "Academics Slam Short-Selling Ban", InvestmentNews.com (December 22, 2008) (Professor Charles Jones from Columbia University studied the effects of the Commission's temporary ban on short selling (Exchange Act Release No. 58592 (Sept. 18, 2008)) for nearly 1,000 financial sector stocks from September 15 through October 8, 2008. On the first trading day following the introduction of the ban, the stocks subject to the ban rose by an average of 10.9%, while the rest of the market rose by 4.5%. During the three weeks of the ban, however, financial sector stocks fell by *more* than the overall market. Additionally, the study observed a significant degradation in liquidity as measured by the widening of bid ask spreads for the impacted stocks.)

## Conclusion

A prudent and disciplined approach is required when reviewing additional regulation to ensure that the core elements of a healthy market are not unnecessarily interfered with. Regulation should promote or seek to minimize the costs of regulation on: (i) liquidity, to ensure that there is a large base of ready buyers and sellers competing for the best prices in the market; (ii) efficiency, to ensure that transaction costs are kept low and communications occur swiftly; (iii) transparency, to ensure that investors and market participants know at what prices they can buy and sell a share, as well as at what prices shares have been bought and sold; and (iv) fairness, to ensure that there is a level playing field in trade execution for all market participants and a participant can get the best execution available in the marketplace. With these principles in mind, we hope that any new short sale regulation will include: (i) a clear articulation of objectives; (ii) a cost/benefit analysis that comprehensively examines the proposed regulation's cost efficiency in achieving those objectives; (iii) participation of those who will be most impacted by the regulation; and (iv) adequate notice to allow for the implementation of requisite system and process changes.

Direct Edge believes that the re-imposition of short sale price restrictions is an ineffective and potentially harmful approach to safeguarding against rapid declines in the capital markets. A price restriction on the short selling of equity securities will only force equity sellers to act unnaturally due to pricing distortions, while still permitting synthetic short activity in the same securities with the potential for greater market abuses. Additional disclosure obligations respecting short interest would further empower regulators to detect abusive trading patterns and provide key insight into the interplay of instruments that are deployed by manipulators in today's marketplace. Further, given the enactment of more stringent regulations respecting naked short selling and fraudulent conduct, the Commission now possesses powerful new tools that it can deploy to surveil, control and combat abusive short selling.

Direct Edge is ready to be of service as the Commission embarks on this process and thanks the Commission in advance for the consideration of these comments.

Sincerely,

Eric W. Hess
General Counsel

cc: Hon. Luis A. Aguilar, Commissioner
Hon. Kathleen L. Casey, Commissioner
Hon. Troy A. Paredes, Commissioner
Hon. Elisse B. Walter, Commissioner
Dr. Eric Sirri, Director of Trading and Markets
James Brigagliano, Deputy Director of Trading and Markets