



May 14, 2009

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

RE: Amendments to Regulation SHO Release No. 34-59748, File No. S7-08-09

Ms. Murphy:

BATS Exchange, Inc. (“BATS”) appreciates the opportunity to comment on the above referenced proposal to amend Regulation SHO (the “Proposal”). BATS supports the Securities and Exchange Commission’s (“SEC” or “Commission”) efforts to assist in stabilizing the U.S. equity markets. Short selling is an important component of market liquidity, and when not engaged in for the purposes of manipulation, has allowed the equity markets to operate efficiently, providing needed price discovery and reducing investor trading costs. Like any trading activity, however, when engaged in for the purposes of manipulation, short selling can be harmful to the markets and undermine investor confidence.

As explained herein, however, BATS does not believe that imposing artificial constraints on short sales effectively prevents such abusive, manipulative behavior, nor does BATS believe such constraints have any impact on restoring investor confidence. Hence, at the outset, BATS questions the propriety of reintroducing a price test to restrict short sales, any iteration of which would reach far beyond an attempt to prohibit manipulation and would negatively impact the efficiency of the markets.

At the same time, BATS recognizes there may be considerable momentum behind this initiative. Accordingly, should the Commission act to implement a price test to restrict short selling, BATS continues to support the imposition of a combination of a circuit breaker followed by a modified uptick rule, consistent with comments BATS recently proposed to the Commission in a joint letter submitted by BATS, the New York Stock Exchange, the Nasdaq Stock Market, and the National Stock Exchange.¹ Moreover, BATS believes that broker-dealers, registered as market-makers, and engaged in bona fide market making activity, whether in the equities or options markets, should be afforded an exemption from any short sale rule adopted by the Commission.

¹ See Letter to the Honorable Mary Schapiro, Chairman, SEC from the United States National Stock Exchanges (March 24, 2009) (“the Exchange Letter”).

I. Necessity for and Effectiveness of a Price Test

As the Commission noted in its Proposal, prior to removing short sale price restrictions in 2007, the Commission studied the issue over a six-year period, and conducted and analyzed the impact of a year-long pilot program. In addition, the Commission studied findings from third party researchers. The results of all of these efforts were publicly-disclosed by the Commission and commented on by the industry. In short, the Commission engaged in a careful, thoughtful, and public process to reach the conclusion supported by the evidence that removing a price test would not be detrimental to the marketplace.

In reaching its conclusion to propose elimination of a price test, the Commission specifically addressed the primary concern it is seeking to address today – whether a price test is necessary to combat manipulation in the form of a “bear raid” fueled by short sellers. The Commission concluded, based on the results of the pilot program, that there was no “association between manipulative short selling, such as ‘bear raids,’ and price test restrictions on short selling.”² The Commission further stated that “[a]lthough there is concern regarding the possibility of manipulation using short sales, we note that the OEA Staff’s Draft Summary Pilot Report did not evidence an increase in manipulative short selling during the time period studied,” and that “the general anti-fraud and anti-manipulation provisions of the federal securities laws would continue to prohibit trading activity designed to improperly influence the price of a security.”³

In its Proposal, the Commission does not offer evidence to suggest that its prior conclusions were erroneous; however, the Commission does request comment on the question of whether market conditions have since changed that would invalidate today the body of academic work and OEA analysis upon which those conclusions were based. Most notably, the Commission references the extreme market conditions that have eroded investor confidence, including “the development of the subprime mortgage crisis and credit crisis in 2007, market volatility, including steep price declines, particularly in the stocks of certain financial services issuers”⁴ in the U.S. and globally.

BATS does not believe that there is sufficient evidence to support the proposition that the extreme market conditions referenced by the Commission would have been prevented or mitigated by a price test on short selling. To the contrary, BATS believes the evidence suggests otherwise. For example, BATS studied the impact on its own market of the recent Commission action to ban short selling in the securities of certain financial industry companies by examining

² See Amendments to Regulation SHO and Rule 10a-1, Exchange Act Release No. 54891, at 19 (Dec. 7, 2006).

³ *Id.* at p. 30.

⁴ Proposal at p. 5.

the trading behavior on BATS during five distinct periods beginning in May 2008, and including the period September 18, 2008 through October 8, 2008, when the ban was in effect, an overall period of dramatic market decline. The following table summarizes the results:

Date Range	Period Description	Long Selling Activity			Short Selling Activity		
		Above Last	= Last	Below Last	Above Last	= Last	Below Last
2008-05-01 thru 2008-05-31	1st Baseline (all of May)	13.17%	25.08%	14.38%	13.36%	22.01%	12.00%
2008-06-01 thru 2008-06-30	2nd Baseline (all of June)	13.95%	25.65%	13.71%	12.22%	22.19%	12.26%
2008-09-01 thru 2008-09-17	Just Prior to Emergency Ban	15.02%	24.22%	15.09%	12.82%	20.28%	12.57%
2008-09-18 thru 2008-10-08	During the Ban	17.62%	24.78%	17.84%	11.95%	16.16%	11.64%
2008-10-09 thru 2008-10-20	After the Ban	17.84%	22.34%	16.66%	13.02%	16.42%	13.72%

For reference purposes, the following table summarizes the performance of the S&P 500 Index during the periods analyzed:

Date Range	Period Description	S&P 500 Index During Period		
		Begin	End	Change
2008-05-01 thru 2008-05-31	1st Baseline (all of May)	1385.97	1400.38	1.04%
2008-06-01 thru 2008-06-30	2nd Baseline (all of June)	1399.62	1280	-8.55%
2008-09-01 thru 2008-09-17	Just Prior to Emergency Ban	1287.83	1156.39	-10.21%
2008-09-18 thru 2008-10-08	During the Ban	1157.08	984.94	-14.88%
2008-10-09 thru 2008-10-20	After the Ban	988.42	985.4	-0.31%

BATS found that in each of the periods measured, only 12% to 13% of all executions on BATS were the result of a short seller trading at a price less than the last execution price reported to the consolidated tape. Equally as often, BATS found that short sellers participated in executions above the last execution price reported to the consolidated tape. In fact, short sellers accounted for 30%-35% of all transactions equal to or higher than the last execution price reported to the consolidated tape. And, importantly, BATS found that over each period long sellers accounted for more shares sold at prices below the last execution price reported to the consolidated tape.

BATS concludes from this data that neither a price test (particularly reimposition of the proposed uptick rule) nor an outright ban on short selling would likely have any discernable impact on restoring investor confidence during a market crisis. Accordingly, BATS strongly urges the Commission to resist implementation of a price test to restrict short selling. At a minimum, BATS requests that the Commission only undertake such an extreme measure after carefully considering and publicly vetting academic research that would support the basis for such action.

II. Price Test

Although BATS opposes implementation of a price test to restrict short selling and does not believe any evidence has been presented that would support such an action, BATS also acknowledges that there is considerable momentum behind the Proposal and, hence, offers comment on the various price test iterations contained in the Proposal. Should the Commission act on the Proposal and adopt some form of a price test, BATS believes the Commission should introduce that price test as a pilot program of between one and two years, and should make

publicly-available information about its consequences. As previously stated, the Commission engaged in a lengthy, deliberative, and public process prior to removing short sale restrictions. Given the potential market structure implications of reintroducing such restrictions, the Commission should proceed with no less caution today and only act with finality after it and third parties have assessed the impact of any such restrictions on the market.

The Proposal asks for comment on three specific iterations of a price test in the equities markets:

- (a) a modified uptick rule (*i.e.*, a market-wide short sale price test based on the NBBO);
- (b) an uptick rule (*i.e.*, a market-wide short sale price test based on the last sale price or tick) similar to former Rule 10a-1; and
- (c) a circuit breaker that would either (i) ban short selling in a particular security for the remainder of the day if there is a severe decline in the price of that security (a proposed “circuit breaker halt rule”) or (ii) impose a short sale price test of the type described in (a) or (b) above in a particular security for the remainder of the day if there is a severe decline in price in that security.

At the outset, BATS does not support imposition of the uptick rule. BATS believes the uptick rule is flawed by virtue of the fact that reference to the last sale price on the consolidated tape is not the best available information of either the cost to buy or sell a security or, more importantly, the direction of the market. In particular, because of delays in reporting transactions to the consolidated tape, any given transaction at any given price may in fact not be the last transaction in the security. Hence, using such transaction as a baseline for establishing a price test seems arbitrary. In addition, based on numerous conversations with market participants, BATS believes reintroducing a tick test would impose tremendous development costs throughout the industry and that there are other effective options available to the Commission that would be much simpler and less burdensome on the industry to implement.

BATS, along with several other exchanges, previously submitted the Exchange Letter to the Commission in support of a circuit breaker followed by a modified uptick rule, which would go into effect after a circuit breaker was reached. The exchanges’ proposal, however, differs in important respects from the modified uptick rule proposed by the Commission. As discussed below, should the SEC determine to act on its Proposal, BATS continues to support the exchanges’ combined circuit breaker and modified uptick rule proposal.

A. Circuit Breaker

BATS supports implementation of a circuit breaker that would go into effect for the remainder of the trading day when a security reaches a price on the consolidated tape that is at least 10% below the previous day’s official closing price. As noted in the Exchange Letter, circuit breakers are a common feature of the equity markets today and would be relatively easy to implement in this context. Circuit breakers also have the added advantage of allowing normal

market activity while a stock is trading within a natural range and short selling is more likely to benefit the market through enhanced price discovery and provision of liquidity. To the extent that the Commission is concerned about potential abusive, manipulative short selling, BATS believes that concern should only interrupt the normal functioning of the market after the circuit breaker threshold is reached. To the extent actual manipulative short selling occurs prior to the imposition of a circuit breaker, enforcement of existing anti-manipulation laws are available to deter such misconduct.

In its proposal, the Commission expressed some concern over the potential for a “magnet effect” associated with a circuit breaker, in which traders rush to execute their short sale orders when they sense that the circuit breaker threshold may be reached, thereby accelerating a decline in price to the threshold level. In the absence of evidence to the contrary, BATS believes this concern is unfounded and does not reflect rational trading behavior. Because short sellers only profit from a decline in the price of a security, it would not be rational for them to rush to sell short when a circuit breaker is close to being implemented, which would harm a short position by removing additional sales volume from the market. To the contrary, BATS believes the existence of a circuit breaker would likely have the opposite effect of dampening selling pressure as the price of a security moved closer to the circuit breaker threshold.

As proposed by the Commission, short selling would be banned following imposition of a circuit breaker, with the exception of short selling under certain available exemptions. BATS believes that a complete halt on short selling at this point would be a draconian measure and would support instead implementation of a modified uptick rule as previously proposed by BATS in the Exchange Letter.

B. Modified Uptick Rule

The modified uptick rule in the Proposal would require a trading center to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution of or display of a short sale in a covered security at a down-bid price. A down-bid price is defined as a price that is less than the current national best bid or, if the last differently priced national best bid was greater than then current national best bid, a price that is less than or equal to the current national best bid.

Similar to the trade through provisions of Regulation NMS, the Commission’s modified uptick rule proposal takes a policies and procedures approach. It permits a broker-dealer to submit an order marked “short exempt” if that broker-dealer maintains policies and procedures reasonably designed to identify that the order is not a down-bid price at the time of submission to a trading center or if it has a reasonable basis to believe the order qualifies for one of seven articulated exemptions to the Commission’s modified uptick rule proposal. Notably, the Commission has not proposed an exemption from its modified uptick rule related to bona fide market making in equities or derivatives.

BATS believes that the Commission's modified uptick rule is inferior to that proposed by the exchanges. In particular, the modified uptick rule proposed by the Commission would require trading centers and market participants to track the national best bid and calculate whether each successive bid is an up, down, zero, or zero+ bid. This would impose a tremendous cost on the industry, both in terms of the programming involved, as well as developing and maintaining systems to manage voluminous amounts of data in a market where the national best bid can change hundreds of times per second. Although certainly feasible, BATS questions whether it would be worth the costs the Proposal would impose on the industry. BATS believes that the modified uptick rule proposed in the Exchange Letter could be implemented by the industry with little comparable effort, and would be more effective at addressing the concerns articulated by the Commission.

By prohibiting short sales against the existing national best bid (*i.e.*, aggressive short sales would not be allowed to hit a bid contributing to the national best bid) regardless of whether that bid is a down-bid, the modified uptick rule proposed in the Exchange Letter is more restrictive than the modified uptick rule contained in the Proposal and, thus, could be more effective at preventing abusive short selling. By implementing such a test only after a circuit breaker threshold has been reached, BATS believes the modified uptick rule proposed in the Exchange Letter strikes an appropriate balance between the desirable goals of maximizing efficiency when the market is operating within normal trading ranges and prohibiting potentially abusive short selling when it is not, while refraining from imposing excessive implementation costs on the industry.

As proposed in the Exchange Letter, broker-dealers and trading centers would be required to maintain policies and procedures reasonably designed to prevent the execution of a short sale order at the prevailing National Best Bid. Trading centers could easily program to prevent the execution of an incoming short sale at the National Best Bid. In addition, similar to the trade through provisions of Regulation NMS, BATS proposes that broker-dealers have the ability to submit a short sale order that is marked "short sale exempt," permitting a trading center to rely on such designation and potentially execute an incoming short sale order against the prevailing National Best Bid with the presumption that the order qualifies for an exemption under the rule.

C. Exemptions

The Commission proposed and BATS supports the following exemptions to its modified uptick rule:

1. An order identified by the broker-dealer as not on a down-bid price at the time of submission of the order to the trading center;
2. There is a delay in delivery;
3. Odd-lot orders entered by market makers under certain circumstances;
4. Domestic arbitrage;
5. International arbitrage;

6. Sales of an over-allotment from an underwriting commitment by a member of the syndicate or group participating in distribution;
7. Riskless principal executions where the broker-dealer is facilitating a customer long sale; and
8. VWAP orders.

The Proposal did not contain a general exemption for market makers engaged in bona fide market making. The Commission noted that it was declining to propose such an exemption; that it believes the provisions relating to when a broker-dealer may mark an order “short exempt” should be limited in scope. The Commission further noted in this context that its proposal to permit broker-dealers to mark an order “short exempt” in connection with a riskless principal transaction would provide broker-dealers with the flexibility to facilitate customer orders.

BATS does not support the Commission’s position as it relates to bona fide market making and believes that any price test rule adopted should include a market maker exemption. Market making in the equities markets is dominated by broker-dealers engaged in electronic proprietary trading on the exchanges. These firms are frequently setting the price on both sides of the market and generally do not hold positions overnight. They do not trade directionally, but rather, capture the spread between the bid and the ask and thrive on other economic incentives inherent in the exchange model (*e.g.*, liquidity rebates). BATS believes this generation of market makers has dramatically enhanced the price discovery process and efficiencies in the equity markets. The Commission’s position would create a serious threat to liquidity in the marketplace.

If the Commission’s concern with implementing a bona fide market making exemption is, as it states, that it could undermine the goals of the proposal, BATS does not believe such concern is warranted. The Commission has presented no evidence to suggest that bona fide market making, non-directional by nature, should be viewed as accelerating a market decline. It is difficult to understand how it could. Instead, if the Commission is primarily concerned that registered market makers would make use of the exemption to trade directionally and accelerate a market decline, BATS would suggest that such conduct would not amount to bona fide market making, but would amount to an abuse of the short sale exemption, and could be subject to disciplinary actions and penalties under existing exchange rules.

In the absence of an exemption for registered market makers engaged in bona fide market making, BATS believes that spreads will widen, resulting in increased trading costs with no discernable benefit towards achieving the goals sought to be achieved through the Proposal. This could potentially lead to further deterioration of investor confidence, something the Commission is rightfully trying to avoid.

For similar reasons, BATS further believes that the Commission should extend its short sale exemptions to equity options market makers engaged in bona fide options market making and that are trading equities as part of their hedging activities. Options market makers generally have more stringent affirmative obligations than those present in the equities markets, and they

are frequently in the position of requiring access to the underlying equity securities to engage in suitable hedging activity. Depriving options market makers that engage in bona fide options market making from the ability to sell short in the equities markets on a bid or a down bid (depending on the price test implemented) would effectively force options market makers to widen the spreads in the options to account for this risk. In a market where the majority of securities are traded in nickel and dime increments, such an action would dramatically increase trading costs.

III. Process

The Proposal is nearly 300 pages in length, contains in excess of 200 specific requests for comment, and amounts to multiple alternative rule proposals – modified uptick rule, uptick rule, circuit breaker followed by a trading halt, or circuit breaker followed by either a modified uptick rule or uptick rule. Each particular iteration of any of these options contains multiple sub-issues requiring resolution, such as the specifics of the parameters and appropriateness of any particular exemptions. BATS is concerned that the Proposal itself is more akin to a concept release, which alone may be unlikely to elicit enough meaningful and detailed comment on each relevant issue to allow the Commission to implement effective rule-making. Accordingly, after considering the comments on the Proposal, to the extent the Commission believes it necessary to implement some form of a price test, BATS respectfully requests that the Commission consider publishing its final proposal for public comment.

BATS appreciates the opportunity to comment on the Commission's proposed amendments to Regulation SHO.

Sincerely,



Eric Swanson
SVP & General Counsel
BATS Exchange, Inc.

cc: The Hon. Mary L. Schapiro, Chairman
The Hon. Kathleen L. Casey, Commissioner
The Hon. Elisse B. Walter, Commissioner
The Hon. Luis A. Aguilar, Commissioner
The Hon. Troy A. Paredes, Commissioner
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