June 19, 2009

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

Re: Amendments to Regulation SHO, File No. S7-08-09

Dear Ms. Murphy:

Three leading investment management firms, Citadel Investment Group, the D. E. Shaw group, and Renaissance Technologies (collectively, the "Managers"), welcome the opportunity to comment on the short selling proposals published by the Securities and Exchange Commission ("SEC" or the "Commission").[1] The Managers share the Commission's and the public's concerns about recent market conditions and the decline in investor confidence and are grateful that the Commission is conducting a thoughtful, deliberative process to determine what approach to short sales is in the best interests of investors and market participants.

We are active market participants that employ many different trading strategies involving a variety of financial instruments and asset classes traded in markets both in the United States and worldwide. Each of us emphasizes rigorous investment research, analysis, and risk management practices in connection with managing money for a diverse group of international and domestic investors. We are recognized for financial innovation and technological leadership. We all engage in short sales as a critical component of our risk mitigation process and a required element of various investment strategies.

We have significant experience with short selling as well as the effects of short sale restrictions. Based on that experience, it is clear to us that short selling is a legitimate and beneficial investment activity that contributes to an orderly, efficient, and fair marketplace for all investors and market participants. We also have observed that unnecessary short sale restrictions disrupt the efficient functioning of markets. Among other things, short sale restrictions impede capital formation, reduce liquidity, result in anomalous pricing, and contribute to increased market volatility.

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1 Securities Exchange Act Rel. No. 59748 (Apr. 10, 2009), 74 Fed. Reg. 18042 (Apr. 20, 2009) (the "Short Sale Proposing Release") (proposing five alternative short sale restrictions).

We understand that the Short Sale Proposing Release has been published in response to the perception of certain investors and market participants that short selling was a significant contributor to recent severe declines and volatility in the financial markets. These critics of short selling activity not only ignore the direct relationship between last year's extreme market conditions and the once-in-a-lifetime collapse in economic fundamentals, but they also fail to consider the breadth of empirical data that clearly indicates short sale restrictions are not necessary or helpful to the markets. In fact, we believe that the implementation of short sale restrictions last fall was itself a significant factor in the deterioration of investor confidence. We further believe that the proposed short sale restrictions similarly would be more damaging to investor confidence than their absence.

Based on the significant and varied trading experiences of the individual members of the Managers, we wish to emphasize the following main points:

First, the empirical data overwhelmingly demonstrate that additional restrictions on short sales would not achieve the Commission's objectives, but rather would hinder market efficiency.

Second, the Managers' extensive investment experiences support recent findings about the adverse market effects of the Commission's short sale ban that commenced in September 2008.

Third, the proposed short sale restrictions are likely to interrupt the orderly functioning of equity and other markets by interfering with legitimate trading strategies that contribute significant benefits to the markets at large, including facilitating capital raising by corporate issuers.

Fourth, while the proposed short sale restrictions might appear to improve certain measures of investor confidence, such restrictions would actually impair investor confidence more broadly over time. The Commission's efforts last summer and fall to strengthen rules designed to prevent manipulative behavior and naked short selling addressed the concerns underlying the lack of investor confidence more effectively than the current proposed broad restrictions on legitimate short sales.

Fifth, the preceding points raise a substantial question about whether any of the proposed short sale restrictions can satisfy the applicable legal standards for rulemaking, such as the need for a cost/benefit analysis of proposed rules.

Sixth, if the Commission decides to pursue the proposed short sale restrictions, any rule should be narrowly tailored to limit the collateral damage to the markets, investors, and the economy. A circuit breaker with bid test that includes appropriate exceptions would be the least harmful approach.

This last point should not detract from our principal comment, however. We urge the Commission not to adopt any of the proposed alternative short sale restrictions because they would not achieve the Commission's objectives, would harm investors, would reduce available risk management tools for investors, and would tend to erode, rather than strengthen, investor confidence.

I. Many Studies Demonstrate the Lack of Empirical Support for the Adoption of New Short Sale Restrictions.

In light of the available empirical evidence about short selling, we believe that a cost-benefit analysis clearly weighs against the introduction of new short sale restrictions. Various studies by the Commission's Office of Economic Analysis ("OEA") and other sources confirm not only that short selling provides many benefits to the markets,[2] but that short sale restrictions fail to achieve their intended goals, and impair the efficiency of the markets in the process. Indeed, recent studies based on data generated during the restrictions on short selling last fall support the Commission's exhaustive analysis of short sale restrictions two years ago.[3]

For example, studies by OEA and various academics have concluded that short sale restrictions are ineffective in preventing accelerating declines in the market (*i.e.*, bear raids). The OEA studied whether "periods of negative returns are associated with unusually high short selling activity" using data from the thirteen-day period preceding the implementation of, among other things, an emergency short sale ban in September of 2008.[4] The results of the study were "inconsistent with the notion that, on a regular basis, episodes of extreme negative returns are the result of short selling activity."[5] The study also found that during periods of extreme negative returns, "short sales put less pressure on prices than other sales."[6] Another OEA study that analyzed short sale price tests using

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[2] As the Commission has repeatedly recognized, short selling provides many benefits to the markets and the economy, including providing market liquidity and price efficiency and correcting upward price manipulation. *See* Short Sale Proposing Release at 18049. Indeed, one critical benefit of short selling that is often overlooked (but which is explored in more detail in these comments) is their use as a risk management tool in connection with establishing long positions.

[3] Securities Exchange Act Rel. No. 55970 (June 28, 2007), 72 Fed. Reg. 36348 (July 3, 2007) (removing restrictions on the execution prices of short sales).

[4] Memorandum from Daniel Aromi and Cecilia Caglio, Office of Economic Analysis, to Chairman Christopher Cox, *Analysis of Short Selling Activity During the First Weeks of September 2008* (Dec. 16, 2008), at 1.

[5] *Id.*

[6] *Id.* at 2.

intraday quote and trade data also found no need for a short sale price test.[7] This study found that "a short sale price test would be most restrictive on short sale orders during periods with little volatility."[8]

Similarly, academic studies of the volatile equity markets in the summer of 2007 do not support the need for new short sale restrictions. One study analyzed extensive market data and concluded that there is "no evidence that the repeal of the uptick rule destabilized prices or otherwise contributed to the bout of volatility experienced by U.S. stocks in late July and early August 2007."[9]

Not only does the empirical data demonstrate that short sale restrictions are ineffective in achieving their stated goal, but studies also show that such restrictions adversely affect the efficiency of markets by distorting prices, increasing volatility, decreasing liquidity, and widening bid/ask spreads. For example, one study found that a majority of the empirical evidence shows that "short sale constraints contribute to overpricing and a reduction in market quality and efficiency."[10] In addition, other empirical evidence indicates that short selling restrictions inhibit certain trading strategies that contribute significant liquidity to the markets.[11] In the following sections, we describe such effects from the point of view of the Managers, which is informed by each firm's many years of active market participation.

We understand that the Managed Funds Association ("MFA") will be submitting a comment letter that discusses studies of short sales and short sale restrictions. We support the key themes expected to be outlined in the MFA comments.[12]

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7 Memorandum from Daniel Aromi and Cecilia Caglio, Office of Economic Analysis, to Chairman Christopher Cox, *Analysis of Short Sale Price Test Using Intraday Quote and Trade Data* (Dec. 17, 2008).

8 *Id.* at 1.

9 Ekkehart Boehmer, et al., *Unshackling Short Sellers: The Repeal of the Uptick Rule* (Abstract) (Dec. 11, 2008).

10 Lawrence E. Harris, Ethan Namvar & Blake Phillips, *Price Inflation and Wealth Transfer during the 2008 SEC Short-Sale Ban* (Apr. 8, 2009), at 11.

11 *See, e.g.,* Ekkehart Boehmer, et al., *Unshackling Short Sellers: The Repeal of the Uptick Rule* (Abstract) (Dec. 11, 2008), at 12.

12 The Managers' views differ in certain respects from those held by the MFA. In particular, although the Managers generally agree with the MFA comment letter's support for a circuit breaker with modified uptick rule, the Managers believe that a circuit breaker with a price restriction in the form of the NASD Bid Test would be more appropriate. *See infra* Section VI.B.

II. The Short Sale Ban in 2008 Harmed Investors and Market Participants.

Empirical studies performed after expiration of the short selling ban on financial sector stocks that the Commission imposed in September 2008 (the "Short Sale Ban")[13] and the experience of the Managers supports the conclusions reached in earlier studies — namely, that unnecessary short sale restrictions cause negative, and unintended, consequences for the fair and efficient functioning of markets and thereby harm issuers and investors alike. Although the Commission's currently proposed short sale restrictions are not apt to lead to an outright ban on short selling,[14] we believe that the experiences from September 2008 are nevertheless informative. The proposed short sale restrictions are likely to have market effects similar to, although perhaps less severe than, those observed during the Short Sale Ban.

In general, studies have shown that the Short Sale Ban did not materially inhibit severe price declines. One study found that the Short Sale Ban did not appear to have any effect on extreme movements of stocks or markets.[15] Another noted that "no study has shown that short-selling constraints reduce the likelihood of crashes."[16] Furthermore, a study by the Investment Industry Regulatory Organization of Canada found that the Short Sale Ban "did not appear to have had any appreciable effect" on the price of securities of financial stocks.[17]

Our own experiences during the Short Sale Ban are consistent with the conclusions reached in these formal studies. One observation of the Managers from the Short Sale Ban is that a short sale restriction tends to reduce liquidity on both the long and short sides of the market. This is because many investors and market participants, including the Managers, use short selling to manage risk and ensure that an overall portfolio maintains a balanced exposure. Even long-biased investment strategies often employ short selling due to certain constraints. For example, a fund that is required to keep a 130/30 long/short ratio must invest 30 cents short for every $1.30 invested long.

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13 Securities Exchange Act Rel. No. 58592 (Sept. 18, 2008), 73 Fed. Reg. 55169 (Sept. 24, 2008); Securities Exchange Act Rel. No. 58572 (Sept. 17, 2008), 73 Fed. Reg. 54875 (Sept. 23, 2008).

14 A short sale restriction could constitute a partial ban or have effects equivalent to those of a total ban, depending on the content and implementation of a final rule. *See, e.g.,* Short Sale Proposing Release at 18052.

15 Abraham Lioui, *The Undesirable Effects of Banning Short Sales*, EDHEC Risk and Asset Management Research Centre (Apr. 2009), at 16.

16 Menachem Brenner and Marti Subrahmanyam, *Short Selling, in* Restoring Financial Stability: How to Repair a Failed System (Viral V. Acharya & Matthew Richardson, eds. 2009), *available at* http.whitepapers.stern.nyu.edu/summaries/ch12.html.

17 Investment Industry Regulatory Organization of Canada, *Study on the Impact of the Prohibition on the Short Sale of Inter-Listed Financial Sector Issuers* (Feb. 2009), at 4.

These types of funds are common and important investment vehicles for many large institutional investors, such as pensions and endowments.

Contrary to popular belief, a significant proportion of short sales are effected by investors who do not have a negative view on the fundamentals of the issuer or the future price of the stock.[18] Approximately 70% of short sales are done as part of a hedging trade. As a general matter, if investors and market participants that would typically reduce their market risk through short sales (whether through single names or indices) are restricted in their ability to execute short sales (or to short broader-based index hedges because the constituents of such indices are restricted from being sold short), we would expect to see a reduction in trading volume, and the consequent reduction in liquidity and efficiency, for both purchases and short sales. This is precisely what happened during the Short Sale Ban.

A second observation from the Short Sale Ban is that the price discovery process does not operate efficiently when short sale restrictions are in place, harming all investors.[19] Because trading volume for both purchases and sales is reduced, there are fewer trades to smooth price movements and narrow bid/offer spreads, and investors therefore may pay prices that are unrelated to issuer fundamentals. As an illustration, during the Short Sale Ban, financial sector stocks (that is, those affected by the restrictions) were subject to extreme price swings in very short periods of time. An academic study found that the Short Sale Ban led to substantial price inflation and resulted in an estimated $4.9 billion transfer of wealth from buyers to sellers.[20] This means that everyday investors, not just short sellers, overpaid for financial stocks by close to $5 billion during the Short Sale Ban.

To illustrate this point another way, we analyzed trading of restricted stocks during the Short Sale Ban to look for instances of unusual price movements, *i.e.,* prices rising more than 2% in a one-minute period followed by a price drop of more than 1% in the following two minutes. This unusual phenomenon occurred on average only 15 times per day during the week before the Short Sale Ban, but 529 such spikes occurred on September 19, 2008, the first day of the ban, and an average of 50 occurred on each of September 22 and 23, 2008. The frequency of such distorted price movements during the

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[18] Only 0.7% of investment management firms (which are commonly believed to be a substantial source of short sales) are dedicated to a short selling strategy. *Credit Suisse Tremont Hedge Fund Index, One for the History Books: Hedge Fund Performance in 2008* (Jan. 2009), at 4, *available at* http://www.hedgeindex.com/hedgeindex/documents/CS%20Tremont%20Hedge%20Fund%2008%20Recap_Final.pdf.

[19] This is consistent with the economic view that artificial restrictions on supply and demand distort the price discovery process and contribute to market inefficiency.

[20] Lawrence E. Harris, Ethan Namvar & Blake Phillips, *Price Inflation and Wealth Transfer during the 2008 SEC Short-Sale Ban* (Abstract) (Apr. 8, 2009).

Short Sale Ban is consistent with the study showing that a significant number of buyers paid inflated prices because of the inability of liquidity providers to sell short.

III. Short Selling Is a Critical Component of Many Trading Strategies.

We now provide examples of widely used, legitimate trading strategies in which short selling is a necessary component. Each of these trading strategies contributes significant benefits to the markets at large, from facilitating capital raising by corporate issuers to providing liquidity and price discovery as discussed in the last section. The proposed restrictions on short selling would reduce these benefits and cause unintended, harmful consequences.

The first example is the convertible securities market. This $350 billion market is a key source of new capital for growth companies and issuers in need of financing. Approximately two-thirds of investment managers in the convertible securities market pursue a relative value strategy in which they purchase convertible securities from issuers and sell short the issuer's common stock to manage and mitigate the equity risk in the convertible securities. With this strategy, short selling is not an expression of bearish views toward an issuer. In fact, most investors in convertible securities have considerable net long exposure to the underlying issuer. The combination of long and short positions operates as an actively managed hedge; it is intended to create an investment that is neutral to the short-term moves in the underlying stock.

As evidenced in the chart at Exhibit A, the Short Sale Ban functioned as a de facto ban on issuing convertible securities, even for companies whose securities were not affected by the restrictions. The primary market for convertibles shut down and secondary trading of convertibles experienced greatly reduced liquidity.[21] Because investors could not manage or mitigate the risks of their holdings, they were unwilling to purchase new issues from companies that were seeking to raise capital; as a direct result, many issuers were thus deprived of a sorely needed source of capital at the worst possible time.[22] Corporations were not able to raise capital through convertible securities at any cost. The Short Sale Ban also caused a severe decrease in liquidity and collapse in prices in the secondary market for convertible instruments, as the inability to hedge such instruments would, in turn, have led to a violation of many investment managers' mandate to hedge long convertible positions.

Our second example concerns statistical arbitrage trading strategies, in which investors seek to profit from numerous small pricing inefficiencies in the equity markets.

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21 *See, e.g.*, Short-Sale Ban Wallops Convertible Bond-Market, Wall St. J. (Sept. 26, 2008), at C2.

22 Even market participants that support the adoption of short sale restrictions acknowledge the need for exceptions to prevent severe negative impacts, including effects on the convertible bond market. *See, e.g.*, Statement of Larry Leibowitz, NYSE Euronext, at the SEC's Roundtable on Short Sale Restrictions (May 5, 2009).

These strategies, which are most often accomplished using algorithmic or systematic trading, are designed not to rely on a prediction as to which way the market will go, so they necessarily involve both long and short sales to maintain some measure of market neutrality. Such strategies make markets more efficient by reducing bid-ask spreads and contributing significant liquidity.[23] The Short Sale Ban deterred statistical arbitrage traders from effecting trades on both sides of the market, and therefore negatively affected liquidity and bid-ask spreads. For example, during the period of September 22 through October 17, 2008, when the Short Sale Ban was in place, such trading on the NYSE declined approximately 20% as compared to the four weeks before and after the ban.[24]

Similarly, one of the most common forms of hedged investing is called long/short equity because, as its name implies, investment managers employing this strategy both buy long and sell short. While some short positions reflect the investor's belief that a certain stock will underperform others, the more common purpose of the short positions is to reduce overall market exposure from the long positions. Investment managers may short specific stocks or they may short sector indices or broad market indices. These short sales play a key role in risk management and played a large part in the relative outperformance of hedged equity investment managers compared to traditional long-only equity managers in the difficult equity markets of 2008. Reduced equity market "beta," or the lower correlation of these investments to broad equity market indices, is a key attribute that many hedge fund investors expect from their investment managers.

If short sale restrictions are adopted, they will significantly reduce the effectiveness of risk management techniques, as illustrated by the examples above, at a time when increasing focus is being placed on reducing risk at individual firms and throughout the system. We believe it would be ill-advised to restrict a means for investors and market participants to offset their own risks and therefore the risks to the system as a whole.

IV. Short Sale Restrictions Will Not Have a Positive Effect on Investor Confidence.

One of the Commission's stated objectives in proposing short sale restrictions is to restore investor confidence.[25] Generalized, unquantified assertions about investor confidence do not respond adequately to the lessons from the consistent, extensive series of empirical studies on short selling restrictions, but our concerns in this area go further. Based on our experiences and the conclusions from the many studies of short sale

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23 *See supra* Section II.

24 *See* NYSE News Releases, *available at* http://www.nyse.com/press/12_2008.html.

25 Short Sale Proposing Release at 18042 (citing "investor confidence" as a significant impetus for the present rule proposal).

restrictions, we believe that adopting any of the proposed restrictions will not improve investor confidence over time.

Investors lose confidence when they doubt the integrity, consistency, and predictability of the markets. Investor confidence at its core is trust that the securities markets reflect prices that are based on complete and accurate values and information and are not based on artificial or manipulative trading. Therefore, in our experience, investors have confidence in deep, liquid, and efficient markets with tight bid-ask spreads that indicate that fair, reasonable pricing is available to all market participants.

Of course, a short sale regulation might seem to give some investors confidence in the short term. Over the longer term, however, short selling contributes to the liquid, efficient markets that actually help build investor confidence. Our experience and the volumes of studies about short sales and short sale restrictions bear this out. Unnecessary short sale restrictions make the markets less reliable, increase trading costs and price volatility, decrease market efficiency and price discovery, provide less protection against upward stock price manipulation, and decrease liquidity and the efficiency of capital allocation. All of those consequences are the types of concerns that give investors pause. As a result, unnecessary short sale restrictions ultimately tend to erode investor confidence rather than promote it.

Various comments, including letters already sent to the Commission and statements at the SEC's May 5, 2009 Roundtable on Short Sale Restrictions, reveal that manipulative short sales and naked short sales rather than short sales in general are a major reason for a decline in investor confidence.[26] The existing regulatory structure

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[26] *See, e.g.*, Letter from United States National Stock Exchanges, to the Honorable Mary Shapiro, SEC Chairwoman, (Mar. 24, 2009), *available at* www.sec.gov/comments/s7-08-09/s70809-49.pdf; Letter from Larry Chlebina, President, Chlebina Capital Management, LLC, to the Honorable Mary Shapiro, SEC Chairwoman (Apr. 15, 2009), *available at* www.sec.gov/comments/s7-08-09/s70809-83.pdf; Letter from Dan Mathisson, Managing Director, Credit Suisse Securities, to Ms. Elizabeth Murphy, SEC Secretary (June 16, 2009), *available at* www.sec.gov/comments/s7-08-09/s70809-3673.pdf; Kevin Cronin, Director of Global Equity, Invesco, Statement at the SEC Roundtable on Short Sales (May 5, 2009), transcript *available at* http://www.sec.gov/spotlight/shortsales/roundtable050509/shortsalesroundtable050509-transcript.pdf; Justin Schack, Vice President, Market Structure Analyst, Rosenblatt Securities, Statement at the SEC Roundtable on Short Sales (May 5, 2009), transcript *available at* http://www.sec.gov/spotlight/shortsales/roundtable050509/shortsalesroundtable050509-transcript.pdf; Dr. Robert Shapiro, Co-Founder and Chairman, Sonecon, LLC, Statement at the SEC Roundtable on Short Sales (May 5, 2009), transcript *available at* http://www.sec.gov/spotlight/shortsales/roundtable050509/shortsalesroundtable050509-transcript.pdf; Brian Conroy, Senior Vice President and Head of Global Equity Trading, Fidelity Management and Research, Statement at the SEC Roundtable on Short Sales (May 5, 2009), transcript *available at* http://www.sec.gov/spotlight/shortsales/roundtable050509/shortsalesroundtable050509-transcript.pdf; William O'Brien, Chief Executive Officer, Direct Edge, Statement at the SEC Roundtable on Short Sales (May 5, 2009), transcript *available at* http://www.sec.gov/spotlight/shortsales/roundtable050509/shortsalesroundtable050509-transcript.pdf.

provides the Commission with effective tools to combat manipulative behavior and problematic naked short sales.

The Commission may use a variety of existing laws to curb manipulation and naked short selling. It may enforce provisions in section 9 of the Exchange Act and Rule 10b-5. It may invoke Rule 10b-21, which prohibits a person from submitting an order to sell an equity security if the person deceives another about its ability to deliver the security for settlement and fails to deliver the security. For years, parts of Regulation SHO have restricted fails to deliver, which can result from abusive naked short sales. Rule 203(b)(1) of Regulation SHO (the "locate" requirement) requires broker-dealers accepting a short sale in an equity security to borrow the security, enter into an arrangement to borrow the security, or have reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due. In 2008, the Commission adopted Rule 204T to tighten delivery requirements even further.

The Commission's Office of Economic Analysis found that the adoption of Rule 204T and amendment of Rule 203 resulted in significant reductions in the number of fails to deliver in the marketplace (in particular, a 56.6% reduction for all securities and a 73.5% reduction for threshold stocks). In addition, the number of securities on the threshold list has declined 87.4% since July 2008, demonstrating the effectiveness of these regulatory enhancements.[27]

Moreover, many large broker-dealers that provide prime brokerage and clearance and settlement services have developed tools to monitor their customers for mismarking of orders and for failures to obtain locates properly. These tools create exception-based reports and are used internally to allow the broker-dealers to discuss short sale delivery requirements with the clients. Broker-dealer records of locates are available for examination by the Commission and FINRA, enabling these regulatory authorities to confirm compliance with Regulation SHO and Rule 10b-21. Commission and FINRA examinations of broker-dealer compliance with the short sale rules can effectively reduce the incidence of naked short selling.

Our view is that the desire to instill investor confidence militates against a short sale restriction rather than in favor of it. We believe that vigorous enforcement of the existing laws, even in the absence of additional regulation, will help to restore public confidence in the financial markets.

[27] Memorandum from Office of Economic Analysis to File, *Impact of Recent SHO Rule Changes on Fails to Deliver* (Apr. 16, 2009), at 4.

V. Given the Relevant Legal Standards, an Adequate Basis for Adopting New Short Sale Restrictions Does Not Exist.

The history of short sale regulation by the Commission and the weighty accumulation of data from academic and empirical studies finding substantial benefits from short sales mean that the Commission faces a daunting task if it now wishes to adopt restrictions on legitimate short sales. In the rulemaking process, the Commission has obligations to engage in reasoned decision-making and to examine the relevant data and articulate a satisfactory explanation for its actions, including a rational connection between the facts found and the choice made.[28] These duties have special force when the agency had short sale restrictions in place for years, made a carefully considered decision to end them,[29] and is now deciding whether to reintroduce them.

Furthermore, we understand that any final action taken on the Short Sale Proposing Release would be subject to certain provisions of the Securities Exchange Act that require the Commission to determine whether the proposed rules are necessary or appropriate in the public interest.[30] When the Commission is obligated to make such a public interest determination, it is also required to consider, "in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[31] This requires the Commission to consider the costs and benefits of the proposed rulemaking and the "economic consequences of a proposed regulation."[32] The empirical evidence from the many academic and Commission studies and experiences of the Managers, as described above in Sections I through IV, raise a substantial question about whether the proposed short sale restrictions can satisfy these standards.

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28 *Motor Vehicle Mfrs. Ass'n v. State Farm Mutual Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

29 In 2007, after a thorough pilot program, extensive scholarly testing, and full notice and comment rulemaking, the Commission reached the considered decision to eliminate all short sale price test restrictions. Securities Exchange Act Rel. No. 55970 (June 28, 2007), 72 Fed. Reg. 36348 (July 3, 2007).

30 Short Sale Proposing Release at 18105 (citing to sections 9(h), 10, and 11A of the Securities Exchange Act, among others).

31 *Id.* at 18103; Securities Exchange Act Section 3(f), 15 U.S.C. 78c(f).

32 H.R. Rep. No. 104-622 at 39 (1996), 1996 U.S.C.C.A.N. 3877, 3901 (House report on bill provision that later became section 3(f)) (in "considering efficiency, competition, and capital formation, the Commission shall analyze the potential costs and benefits of any rulemaking initiative, including, whenever practicable, specific analysis of such costs and benefits. The Committee expects that the Commission will engage in rigorous analysis ...."); *Chamber of Commerce v. SEC,* 412 F.3d 133, 144 (2005) (Commission has a "statutory obligation to do what it can to apprise itself — and hence the public and the Congress — of the economic consequences of a proposed regulation before it decides whether to adopt the measure").

VI. Only A Narrowly Tailored Short Sale Restriction Should Be Considered.

As previously noted, we do not believe that the proposed short sale restrictions are necessary or appropriate in the public interest or for the protection of investors. We therefore urge the Commission not to adopt any of the proposed short sale restrictions. If the Commission nonetheless decides to adopt a form of restriction, it should be narrowly tailored to minimize the collateral harm to the markets and economy and to address concrete problems that have been identified and documented with empirical data. The proposed broad market rules (*i.e.,* the modified uptick rule and uptick rule) would not meet these requirements and therefore would be unduly restrictive.

A stock-by-stock circuit breaker with a price test that includes appropriate exceptions for specific types of domestic arbitrage, trading in index products, and bona fide market making would cause the least market harm. We now discuss details of these features, such as the threshold for and length of a circuit breaker, the nature of the price test, the terms of exceptions, and the desirability of a pilot program before the Commission adopts a permanent rule.

A. Stock-by-Stock Circuit Breaker

A stock-by-stock circuit breaker price test, when triggered by a severe decline in the price of a particular security during the trading day, would curb short selling activity in that particular security for a specified period during that day. This approach would be superior to both a market-wide price test and a circuit breaker with a trading halt. It would more narrowly focus the regulatory restrictions on trading conditions in particular securities that may raise concerns about potential "bear raids," and would minimize the impact on legitimate short selling and normal market activity in all remaining securities. The other proposed rules would cast too wide a net, restricting short selling in situations that implicate no legitimate policy considerations. For example, a market-wide price test that is in effect at all times limits short selling in securities that are experiencing no downward pressure at all. Similarly, a circuit breaker with a trading halt would prohibit all short selling activity during periods of high volatility, when short selling may provide much needed liquidity and price discovery to the market.

1. Threshold for Circuit Breaker

To the extent that a stock-by-stock circuit breaker price test is considered, the Commission should carefully examine the available market data to determine the appropriate threshold. In our view, the appropriate level for triggering a circuit breaker is one that allows the market to function without intervention a majority of the time, taking effect only during extraordinary market conditions. It is difficult to determine the most appropriate level without considering how often the circuit breaker would be triggered in both extreme and normal market conditions. Nevertheless, we would encourage the

Commission to consider a higher level than the preliminary proposal of a 10% threshold[33] measured from the prior day's closing price. At a 10% threshold, each stock from the S&P 500 index would hit the threshold an average of 1-3 times per year during normal market conditions, while under more volatile market conditions 10-15% of S&P 500 stocks (or 50-75 stocks) would trigger the circuit breaker in any given day.[34] Clearly, the prior experience of self-regulatory organizations with administering various trading halt provisions (the "SRO Circuit Breakers") suggests that a costly and inefficient revision process would be the likely outcome if the threshold were set too low.[35] Indeed, a thorough analysis of the most appropriate threshold for the circuit breakers would avoid the many rule amendments and related system changes that were necessitated in the past by changes to the SRO Circuit Breakers.

We refer you to the comment letter to be submitted by the MFA, which will provide extensive data concerning the impact of various circuit breaker levels under different conditions and for different stocks. That data indicates a level of 15% or 20% may fit the policy goals of the Commission while not impairing normal trading activity. Another option we urge the Commission to consider is to have the circuit breaker be triggered at the stated percent below the stock's *opening* price, rather than the prior day's closing price, so that important announcements made after normal trading hours by issuers can be taken into account by investors.

2. Length of Circuit Breaker

The period in which a circuit breaker is in effect should be guided by several principles. Our comments are based on extensive experience with the old uptick rules as well as current circuit breakers that apply in other circumstances. First, a circuit breaker price test should only be in effect long enough to reestablish equilibrium between buying and selling interests. Second, once the circuit breaker threshold is triggered, the duration

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[33] Short Sale Proposing Release at 18066.

[34] Ana Avramovic, Credit Suisse, *Ticking Off the Shorts: Public Calls to Restrict Short Selling* (Apr. 23, 2009), *available at* https://tradeview.csfb.com/public/bulletin/ServeFile.aspx?FileID=12012&m=-409136585.

[35] The SRO Circuit Breakers, as adopted in 1988, called for a one-hour trading halt if the DJIA declined by 250 points from the previous day's close, and a two-hour halt in the event of a 400 point decline. *See* Securities Exchange Act Rel. No. 26198 (Oct. 19, 1988), 53 Fed. Reg. 41637 (Oct. 24, 1988) (approving rules of the Amex, CBOE, NASD, NYSE). These parameters were amended in 1996 to limit the duration of trading halts, and again in 1997 after it was determined that the 250 and 400 point thresholds were too low given the substantial increase in the value of the DJIA in the years since 1988. The 1997 amendments increased the trigger values for the one-hour and two-hour trading halt scenarios to 350 and 500 points, respectively. *See* Securities Exchange Act Rel. No. 38221 (Jan. 31, 1997), 62 Fed. Reg. 5871 (Feb. 7, 1997). The SRO Circuit Breakers were revised again in 1998 to put into place circuit breakers triggered by certain percentage declines. *See* Securities Exchange Act Rel. No. 39846 (Apr. 9, 1998), 63 Fed. Reg. 18477 (Apr. 15, 1998).

of the price test should depend on the time of day. When a threshold is triggered later in the day, the price test should go into effect for a short time period, as compared to a circuit breaker that is triggered earlier in the day, since a circuit breaker that is triggered late in the trading day could cause market disruption.[36] Third, the circuit breaker should allow the stock to close with the market. Therefore, if the circuit breaker threshold is triggered within the last thirty minutes of the trading day, no price test should go into effect. In this regard, the current approach of the SRO Circuit Breakers would be an appropriate method to consider when structuring a circuit breaker price test, if the Commission chose to adopt one.

B. Nature of Price Test

If the Commission were to implement a stock-by-stock circuit breaker price test, the Managers would favor the use of the bid test previously employed by the NASD ("NASD Bid Test"), rather than the proposed uptick rule or proposed modified uptick rule described in the Short Sale Proposing Release. We believe that the approach of the NASD Bid Test would be appropriate for several reasons, especially given that market participants are familiar with it and it worked as intended for many years.

1. Bid v. Tick Test

As an initial matter, it is worth emphasizing that any price test based on last sale data (commonly referred to as a tick test) would be unworkable in today's trading environment, which is characterized by multiple trading venues, rather than dominated by one or two significant markets for any particular security.[37] With the current market structure, quotations more accurately reflect current prices for a security than last sale prices. Specifically, last sale prices are only required to be reported within 90 seconds, not immediately, and they are published in reporting sequence rather than trade sequence. Even transactions that are executed and reported automatically may be out of sequence if they occur in different trading centers. Therefore, if short sale restrictions were to be based on the last sale price, the manner in which trades are reported would create up-ticks and down-ticks that have no relation to the current price of the security. In contrast to the treatment of last sale prices, bids are sequenced in trading order across trading centers. Thus, for those covered securities for which a significant amount of trading occurs

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[36] *See* Short Sale Proposing Release at 18066. The type of market disruption that the Commission is concerned about was noted when the Commission approved changes to the SRO Circuit Breakers. Specifically, the Commission noted that "in order to achieve an orderly daily close and permit completion of market activities in a fair way, the Commission firmly believes that every attempt should be made to reopen the markets after the triggering of a circuit breaker if it is triggered earlier in the day." The Commission also noted that "investors have come to rely on the markets being open until 4:00 pm, and make their investment decisions on that basis. When an early close prevents investors from making their trades, resulting investment decisions become colored by uncertainty." *See* Securities Exchange Act Rel. No. 39846 (Apr. 9, 1998), 63 Fed. Reg. 18477, 18480 (Apr. 15, 1998).

[37] *See* Proposed Rule 201(b) in Short Sale Proposing Release at 18109.

manually, or in multiple trading centers, a price test based on the national best bid would be a fairer, more practical means of regulating short selling than a test based on the last sale price.

Moreover, we do not believe that the distinction between quotations and last sale information should affect this conclusion. Although quotations propose transactions, whereas the last trade price reflects an actual trade, quotations for all covered securities must be firm.[38] As a result, quotations provide reliable information to the marketplace that enables broker-dealers to discharge their duty of best execution while also allowing investors to make informed investment decisions. The NASD's use of its Bid Test for over ten years confirms this conclusion. In short, we agree with the Commission's preliminary view that a price test based on bids would have advantages over a tick test.[39]

2. NASD Bid Test v. Proposed Modified Uptick Rule

We also believe that the NASD Bid Test would have advantages over the modified uptick rule as discussed in the Commission's proposal. The proposed modified uptick rule would prevent the execution or display of a short sale order at a down-bid price, where 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 the current national best bid, a price that is less than or equal to the current national best bid."[40]

The NASD Bid Test prohibited selling short "at or below the current national best (inside) bid when the current national best (inside) bid is below the preceding national best (inside) bid," subject to certain exemptions.[41] When the NASD Bid Test was originally approved by the Commission, the NASD described its operation for NASD members as follows:

> Nasdaq calculates the inside or best bid from all market makers in the security . . . and disseminates symbols to denote whether the current inside bid is an "up bid" or a "down bid" so that members will have that information at their fingertips when effecting short sales. Specifically, an "up bid" is denoted by a green "up" arrow symbol and a "down bid" is denoted by a red "down" arrow. Accordingly, absent an exemption from the rule, a member cannot effect a short sale at or below the inside bid in a security in its proprietary account or an account of a

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38 *See* Rule 602 of Regulation NMS, 17 C.F.R. 242.602.

39 Short Sale Proposing Release at 18043.

40 *See* Proposed Rule 201(a)(2) in Short Sale Proposing Release at 18107.

41 Former NASD Rule 3350; *see also* Securities Exchange Act Rel. No. 34277 (June 29, 1994), 59 Fed. Reg. 34885 (July 7, 1994) ("Bid Test Adopting Release").

customer if there is a red down arrow next to the security's symbol on the screen.[42]

However, a member may effect a short sale at or below the inside bid in a security if there is a green arrow representing an up bid when the short sale commences.[43]

In our view, the Commission's proposed modified uptick rule would be more restrictive and more complicated to implement than the NASD Bid Test. For example, consider the following trading scenario: The current national best bid in a security is $47.00 with the displayed size of 100 shares, with a reserve size of 400 shares that are not displayed. The immediately preceding national best bid was $46.98. Under the NASD Bid Test, the price of $47.00 would be considered an "up bid." In such cases, a market maker that receives a customer market order to "sell short" 1,000 shares would be free to "walk the stock down" — that is, execute the first 500 shares at the price of $47.00 and then fill the remaining 500 shares at $46.99, the next price level down. Under the proposed modified uptick rule, however, the market maker would not be permitted to fill any part of the customer order at the price of $46.99, because it would result in the execution of a short sale order at a down-bid price. Accordingly, the portion of a customer market order to sell short that is larger than the available depth of liquidity likely would remain unfilled.

In addition, unlike the NASD Bid Test, the proposed modified uptick rule would require market participants to program their order entry and trade execution systems to anticipate possible down-bid executions.[44] The Short Sale Proposing Release offers no explanation for changing the NASD Bid Test to create the more restrictive, complicated modified uptick test, and we do not see the need for such a change.

3. Increment for a Price Test

The Managers believe that a penny or a single tick is the appropriate increment for a price test. Requiring any larger increment would prevent short sales in scenarios where a stock moves upward in small increments or in a choppy pattern, rather than a straight line. The larger the increment, the more a price restriction would serve as an effective ban on short selling.[45]

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42 *SEC Approves Short-Sale Rule for the Nasdaq Stock Market,* NASD Notice to Members 94-68 (1994).

43 (Emphasis added).

44 Many market participants already have system code based on the NASD Bid Test that could be leveraged if the Commission were to adopt a circuit breaker with a bid test.

45 *See, e.g.,* Memorandum from Daniel Aromi and Cecilia Caglio, Office of Economic Analysis, to Chairman Christopher Cox, *Analysis of Short Sale Price Test Using Intraday Quote and Trade Data* (Dec.

C. Exceptions to Short Sale Price Restrictions

The Managers believe that any short sale restriction should have appropriate exceptions. We support adoption of all of the exceptions that the Commission proposes, although we believe one such exception (the domestic arbitrage exception) should be amended slightly. We also believe the Commission should include two additional exceptions — for trading in exchange-traded funds and other index products and for bona fide market making and related hedging activity — in any short sale price restriction.

1. Exception for Domestic Arbitrage

The Release proposes to except certain "domestic arbitrage transactions" that are essentially contemporaneous and are effected to lock in a gross profit or spread resulting from a current differential in pricing between two securities.[46] The Managers support such an exception as a key risk management tool but believe that the proposed exception as found in the Short Sale Proposing Release would be too limited, given the emphasis on the contemporaneous nature of the transactions. The language in the proposing release would fail to recognize that bona fide hedging activities may involve some delay between the transaction in which the first leg of the hedge is established and the subsequent transaction in which the second, offsetting leg is completed.[47] The exception should be broadened to cover any transaction in connection with domestic arbitrage, even if not contemporaneous in time. Our concern is illustrated more fully below with an example that shows how hedging is not merely a one-time static event, but often has to be adjusted over time in a dynamic process as market conditions change.

For example, a convertible investor may implement a delta hedging strategy that involves the purchase of a certain convertible security and the contemporaneous short selling of the underlying security, as permitted under the proposed exception. Suppose, however, that the volatility of the underlying security changes over several days, thereby necessitating an adjustment to the exposure to the underlying security to maintain a constant delta. Under the proposed exception, such an adjustment would be subject to the proposed short sale restrictions, thereby restricting the convertible investor's ability to appropriately hedge its position. We believe that the proposed exception should be broadened to include such bona fide hedging activities. Such an expanded exception would not only benefit markets by both enhancing market efficiency and liquidity, but it

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17, 2008), at 1-2; Erik Sirri, Director of the SEC's Division of Trading & Markets, Statement Before the Commission Open Meeting (Apr. 8, 2009).

46 Short Sale Proposing Release at 18056.

47 *See, e.g.,* Securities Exchange Act Rel. No. 15533 (Jan. 29, 1979), 44 Fed. Reg. 6084, 6090 (Jan. 31, 1979).

also would promote capital formation, an important economic policy goal, by ensuring that the market for convertible securities remains robust.

2. Exception for Exchange Traded Funds ("ETFs") and Other Index Products

We also recommend that the Commission except ETFs and other index products from any short sale restrictions, as was the case when the prior uptick rules were in place. ETFs and other index products are one of the most important tools used to hedge long exposures. Imposing short sale restrictions on these products would significantly hamper the ability of market participants to engage in these hedges. Moreover, there is no policy reason for applying short sale restrictions to ETFs and other index products. ETFs are designed to provide investment results that correspond generally to price and yield performance of securities included in a particular index or securities portfolio. In light of the composite and derivative nature of ETFs, the Commission previously concluded that trading in ETFs would not be susceptible to the practices that Rule 10a-1 is designed to prevent. In particular, the Commission found that ETFs should rise or fall primarily based on changes in the net asset value of the component stocks of the particular index.[48] The same policy rationale applies today to ETFs, as they generally are not susceptible to the practices that Rule 10a-1 was designed to prevent (*i.e.*, bear raids).[49]

3. Exception for Bona Fide Market Making and Related Hedging Activity

It is critical to include in any proposed short sale restriction an exception for both bona fide market making in securities covered by any short sale restrictions as well as bona fide market making and hedging activity related to bona fide market making in derivative and exchange traded funds ("ETFs") related to such securities. The Short Sale Proposing Release proposes a market-making exception only for one of the five options — the circuit breaker with a trading halt — and not for a circuit breaker with a price test.[50] The Commission should include the exception for any kind of short sale restriction it imposes.

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48 Securities Exchange Act Rel. No. 48709 (Oct. 28, 2003), 68 Fed. Reg. 62972 (Nov. 6, 2003) ("2003 Short Sale Proposing Release").

49 *See* Class Relief for Exchange Traded Index Funds, SEC No-Action Letter (Oct. 24, 2006) (noting that, due to their composite and derivative nature, ETFs would not be susceptible to the practices that the former uptick rule was designed to prevent); *see also* Letter re: SPDRs (Jan. 27, 1993); Letter re: MidCap SPDRs (Apr. 21,1995); Letter re: Select Sector SPDRs (Dec. 14, 1998); Letter re: Units of the Nasdaq-100 Trust (Mar. 3, 1999); Letter re: ETFs (Aug. 17, 2001) (class letter); Class Relief for Exchange Traded Index Funds, SEC No-Action Letter (Oct. 24, 2006); 2003 Short Sale Proposing Release at 62988.

50 Short Sale Proposing Release at 18067.

Market makers play a crucial role in providing liquidity to the markets, and without appropriate relief, short sale restrictions would significantly hamper their ability to provide such liquidity. Last fall the Commission recognized the value of market maker short selling activity to the markets as a whole when it excepted such bona fide market making and related hedging activity from the Short Sale Ban.[51]

As noted by the Commission in the fall of 2008, the purpose of these exceptions was to permit market makers to continue to provide liquidity to the markets, facilitate customer buy orders and other orders, and otherwise comply with their obligations as market makers.[52] Such an approach is consistent with the former NASD Bid Test, which exempted bona fide market makers in options, as well as equities.[53] We recommend the Commission include the same exceptions in any short sale restrictions that it may adopt in its current rulemaking process.

We disagree with the reasons stated in the Short Sale Proposing Release for not including an exception for market making. The Short Sale Proposing Release first argues that the market making exception is unnecessary given that, under Rule 10a-1, various exchanges did not rely on such an exception.[54] This argument is flawed in that the New York Stock Exchange ("NYSE") and other exchanges subject to Rule 10a-1 were, in the past, primarily agency, not dealer, markets and thus did not need any such exception. In contrast, Nasdaq was always predominantly a dealer market, thus necessitating the market maker exception in the NASD Bid Test. Today, most markets are quote-driven with competing market makers, like the historical Nasdaq market covered by the NASD Bid Test,[55] so the exemption would be applicable today. Second, we dispute the suggestion that the market maker exception would provide too large an exception to a short sale restriction, thus limiting its effectiveness. We believe that the benefits to the markets provided by market maker short selling far outweigh the concerns raised about

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51 Specifically, the Commission stated that the Short Sale Ban did not apply to "registered market makers, block positioners, or other market makers obligated to quote in the over-the-counter market, in each case that are selling short [certain securities] as part of bona fide market making in such security." Securities Exchange Act Rel. No. 58592 (Sept. 18, 2008), 73 Fed. Reg. 55169, 55170 (Sept. 24, 2008). In addition, the Short Sale Ban did not apply to "any person that is a market maker, including an over-the-counter market maker, that effects a short sale as part of a bona fide market making and hedging activity related directly to bona fide market making in (a) derivative securities based on Covered Securities; and (b) exchange traded funds and exchange traded notes of which Covered Securities are a component." Securities Exchange Act Rel. No. 58611 (Sept. 21, 2008), 73 Fed. Reg. 55556 (Sept. 25, 2008).

52 *See, e.g.*, Securities Exchange Act Rel. No. 58592 (Sept. 18, 2008), 73 Fed. Reg. 55169 (Sept. 24. 2008).

53 *See* Bid Test Adopting Release.

54 Short Sale Proposing Release at 18059.

55 *See, e.g.*, Nasdaq Stock Market Rule 4613(a).

the potential broadening of the permitted short selling activities. Moreover, any opportunities for abusive short selling raised by such an exception for market makers could be effectively addressed through a rigorous enforcement program and through the enhancements to Regulation SHO put into place in the fall of 2008.

D. Other Considerations

1. Implementation Lead Time

The three-month implementation period currently contemplated in the Short Sale Proposing Release would not be sufficient.[56] Many changes would be necessary, including programming systems changes, developing necessary infrastructure, processes and surveillance mechanisms, and, if required, drafting and implementing appropriate policies and procedures. As such, the industry would need significant lead time before a rule could take effect.[57] In connection with both Regulation SHO and Regulation NMS, the Commission allowed market participants significant lead time to make the necessary arrangements to be in compliance on the compliance date. Regulation SHO was adopted in July of 2004 and compliance was not required with respect to the order-marking and locate requirements until January of 2005.[58] Regulation NMS was adopted in June of 2005 and market centers were not required to be in full compliance until October 2007.[59]

2. Additional Study or Pilot Program

If the Commission believes, after reviewing all comments, that reintroducing a short selling restriction could be in the public interest, it should undertake additional study before adopting a permanent rule. For example, the Commission could perform a comprehensive market break study to determine what caused the extreme volatility in the markets last fall, like the study conducted after the October 1987 market break.[60] Or, in the alternative, a pilot program comparing a group of securities with a short sale restriction against a control group would allow the Commission and the broader community to evaluate the effectiveness of the rule and identify any unintended consequences before the Commission makes a final decision. We believe that such additional fact-gathering would help the Commission verify its concerns about investor confidence while also ensuring that its actions address legitimate policy concerns.

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56 Short Sale Proposing Release at 18042.

57 If the Commission were to adopt a short selling restriction without a pilot program, we would have similar concerns about the time to implement such a rule.

58 *See* Securities Exchange Act Rel. No. 50103 (July 28, 2004), 69 Fed. Reg. 48008 (Aug. 6, 2004).

59 *See* Securities Exchange Act Rel. No. 55160 (Jan. 24, 2007), 72 Fed. Reg. 4202 (Jan. 30, 2007).

60 *The October 1987 Market Break: A Report by the Division of Market Regulation*, U.S. Securities and Exchange Commission (Feb. 1988).

The use of a pilot program would be consistent with the Commission's action in connection with repealing Rule 10a-1 and eliminating SRO price tests when the Commission had a lengthy pilot program. The Commission should follow the same course with respect to reimposing any similar restriction. A pilot program would allow the Commission and the broader community to compare the trading behaviors that occur both in the presence and the absence of short sale restrictions and the effect on different categories of securities. Data gathered in a pilot program would supplement data gathered by the Commission and submitted by commenters to the Short Sale Proposing Release. The pilot program should be in effect for a sufficient period of time for the Commission to collect statistically significant data, but in no event should be shorter than a year.

CONCLUSION

In summary, based on the Managers' experiences as significant capital markets investors, we strongly urge the Commission not to adopt the proposed short sale restrictions. We believe that any such restrictions will impair the efficient and fair functioning of the markets and thereby harm investors.

Thank you for the opportunity to comment on these proposals.

Sincerely,

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Citadel Investment Group, L.L.C.

John Liftin
Managing Director and General Counsel
The D. E. Shaw Group

Mark Silber
Executive Vice President
Renaissance Technologies

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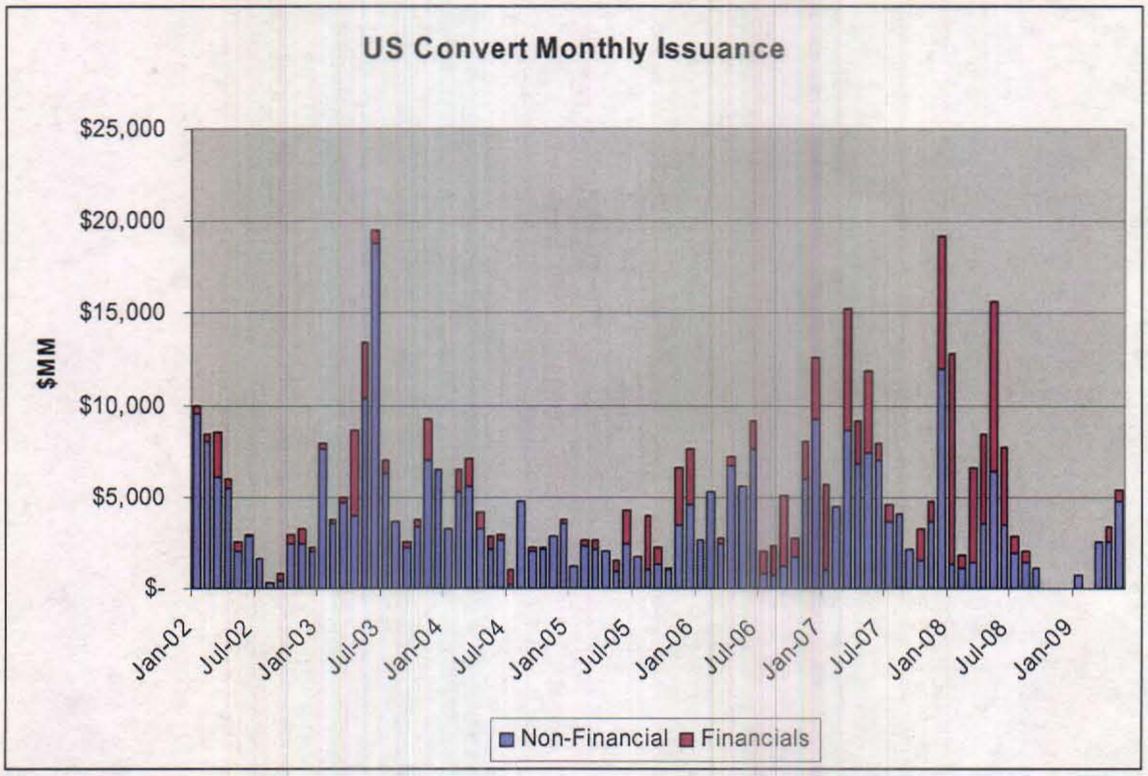
EXHIBIT A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