EWT
LLC

June 19, 2009

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

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

Dear Ms. Murphy:

EWT, LLC ("EWT") appreciates the opportunity to provide the Securities and Exchange Commission (the "Commission") with comments on the proposed amendments ("Proposed Amendments") to Regulation SHO under the Securities Exchange Act of 1934 (the "Exchange Act"). Release No. 34-59748, 74 Fed. Reg. 18042 (Apr. 20, 2009) (the "Release").

I. Overview

EWT strongly supports the Commission's efforts to restore investor confidence in U.S. financial markets, including through appropriate measures to limit abusive short selling. Critical to investor confidence, in our view, is the preservation of the deep liquidity that investors have come to expect in U.S. markets for publicly traded securities – liquidity that depends crucially on committed market making firms.

- Bona fide market makers – in notable contrast to directional short sellers who bet on market declines – create trading opportunities for investors by buying and selling securities in both advancing and declining markets.

- Market making firms offer investors one of the most important kinds of confidence – the confidence that when they seek to sell or buy a security, good markets or bad, someone will be there to buy or sell it.

Thus, it is essential that Commission rules protect the ability of market makers, when genuinely serving as liquidity providers, to offset their risks on both sides of the market, long and short.

Investor confidence also rests importantly on orderly and rational relationships across markets and products. Gaps between the behavior of indices and their underlying components, or in the movements of commodities and futures prices for comparable instruments, can significantly undermine faith in the stability of those markets. The Commission therefore should ensure that its rules do not create or exacerbate instability by imposing unnecessary or inconsistent restrictions on broad based index or other products traded in multiple forms and venues.

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II. **Background**

EWT is a proprietary, self-clearing broker-dealer registered with the Commission under Section 15 of the Securities Exchange Act of 1934. EWT is a member of the Financial Industry Regulatory Authority, the New York Stock Exchange, NASDAQ and, together with its affiliates, operates across more than 25 other exchanges and market centers around the world. Engaging in direction-neutral algorithmic trading and using proprietary trade execution technology, EWT has a significant market share in several asset classes and is a major, active participant in the public equities markets. EWT does not engage in customer transactions and derives its income from its proprietary market making activities. As a market maker, EWT provides significant liquidity to the marketplace and investors. It does not seek to profit from "bets" on downward market movements, through short sales or otherwise.

As an active participant in the equities market, EWT strongly supports the efforts of the Commission to maintain and promote fair and orderly markets through carefully considered rule-making. Recent actions of the Commission and its staff to address concerns about the spreading of false rumors, abusive "naked" short selling,[1] and other manipulative conduct, as well as concurrent initiatives to address equities settlement and failures to deliver, have had an immediate impact.[2] Coupled with rigorous enforcement, such activities ensure the integrity of our public equity markets, and this integrity ultimately forms the bedrock of investor confidence.

The foundation of market integrity and investor confidence is a sound rule-making process. Investors from all corners of the globe choose to invest their savings with confidence in our country's financial markets because they know that these markets are governed by fair and transparent rules in a manner which is unparalleled elsewhere. The multi-year process which resulted in the July 2007 removal of short sale price test restrictions was a model of careful, deliberate, and transparent rule-making, including extensive public participation, rigorous application of econometric analysis, and the very practical and scientific approach of

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1 An "abusive 'naked' short sale" is not defined in Regulation SHO, but we understand it to be a short sale made without having stock available for delivery (or locating such stock) and then intentionally failing to deliver stock within the standard three-day settlement cycle. The Commission has previously provided guidance in this regard in Release No. 34-56212 (Aug. 7, 2007), 72 Fed. Reg. 45544 (Aug. 14, 2007), and Release No. 34-54154 (July 14, 2006), 71 Fed. Reg. 41710 (July 21, 2006).

2 Recent data indicates that interim final temporary Rule 204T has been quite successful in meeting its goal of reducing persistent fails to deliver. However, technical details of the Rule have resulted in unintended adverse consequences including a significant and troubling reduction in credit available to broker-dealers, and substantially increased market volatility around the open and close of trading. We discuss these consequences in our November 25, 2008, comment letter on Rule 204T, where we present simple technical remedies to address these issues should the rule be adopted on a permanent basis. Letter from Peter Kovac, Chief Operating Officer and Financial and Operations Principal, EWT, to Florence Harmon, Acting Secretary, SEC, dated November 25, 2008.

conducting a pilot program to test various hypotheses regarding the impact of proposed regulation on market microstructure.[3]

While we strongly urge the Commission to apply the same rigorous standards of analysis when evaluating the Proposed Amendments as it did in its July 2007 process, we recognize nevertheless that under today's extraordinary circumstances and constraints, the options are limited. In our comments below, we thus focus solely on certain technical aspects of the Proposed Amendments which we feel are essential to maintaining fair and orderly markets. In particular, while the Proposed Amendments are intended to promote investor confidence by curtailing abusive short selling on the securities of individual issuers, without the proper exemptions the amendments will unnecessarily restrict bona fide market making and risk-mitigating hedging activities, both of which are fundamental to the market integrity and stability upon which investor confidence depends.

III. Market Makers and Market Integrity

Bona fide market making is an essential part of the financial markets. The role of market makers is, in fact, to ensure that there *are* financial markets – market makers create a two-sided market for securities, enabling investors to buy or sell at a fair price. This most basic function of the markets is among the cornerstones of investor confidence.

The service market makers provide is distinct from other investment and trading activity in that a market maker does not seek to profit from speculation that a security will increase or decrease in value. In the rule-making process, it should be recognized that there is an important distinction between speculative activity regarding an individual security, and non-speculative activities such as bona fide market making. This fundamental distinction has been

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3 The extensive history of public participation in and comment on the July 2007 removal of short sale price restrictions is covered in the Release (74 Fed. Reg. at 18042, 18044-46). In addition to numerous academic studies of the data, the Commission received 27 comment letters; only two commenters opposed the removal of short sale price restrictions. Not surprisingly, despite all the recent hyperbole surrounding the repeal of the uptick rule, there has not yet been a credible critique of either this rule-making process, nor of the underlying rationale for the removal of short sale price restrictions. Critics who cite a correlation between increased volatility and the removal of short sale price restrictions misinterpret the data and, more fundamentally, confuse correlation with causality. During the Reg SHO Pilot period, when short sale price restrictions were removed from fully one-third of the stocks in the Russell 3000, the market trended upward and volatility generally trended downward. Both trends only reversed with the eruption of the sub-prime mortgage crisis in the summer of 2007. *See* Credit Suisse Portfolio Strategy, AES Analysis (April 23, 2009). Just as the removal of the restrictions in 2004 did not drive the market upward, the completion of the removal of the restrictions in 2007 did not drive the market downward. The common-sense distinction between correlation and causality is further demonstrated by the fact that the equities markets plummeted more than 20% in March of 1938, one month after the adoption of the original short sale price restrictions – few rational observers would attribute that broad market decline to the adoption of short sale price restrictions.

implicit in the discussion to date, and no serious commenter has claimed that market making and risk mitigating hedging activities have anything but a dampening effect on market volatility, but it bears repeating that market making has a significant beneficial impact and ought not to be discouraged through unnecessary and adverse regulation.

A. Role of Market Makers

More than anything else, investor confidence is dictated by the investor's actual interaction with the market. It is a testament to the soundness of our financial markets that investors unquestioningly expect that they can buy or sell exchange-listed equities at any time in a fair and liquid market. However, in the broader context of all financial markets, this experience is the exception, not the norm. Numerous other markets lack competitive two-sided markets, and the inability of investors to transact in these markets over the past year has seriously eroded confidence in those markets.[4] The erosion of investor confidence in the basic functioning of the markets is a serious concern, for the ultimate crisis of confidence – a "run" on the bank – is sparked by a fear that transactions can no longer occur. The ability to transact freely in a market is a basic and fundamental component of investor confidence.

The role of the market maker is to provide a continuous and regular two-sided quotation to the market. The market maker's actions ensure that the individual investor is able to transact freely in the market, which is a fundamental prerequisite of investor confidence. Moreover, the investor's knowledge that tomorrow, just like today, there will be a competitive and fair two-sided quotation in the markets, provides the confidence that is the best defense against a "run" on the bank sparked by the fear of the market disappearing.[5]

Competitive market making not only facilitates price discovery, but also creates significant depth of liquidity in terms of both shares available for purchase or sale, and shares available at multiple price points. This depth of liquidity dampens volatility in the market: with multiple market makers willing to buy thousands or tens of thousands of shares it becomes less likely that a handful of transactions can move the market in any direction. Just as the unpredictability and volatility of a market weakens investor confidence, the dampening of

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4 For example, the freezing of the markets for auction rate securities in 2008 severely undermined investor confidence in that market. *See* New York Times, "New Trouble in Auction-Rate Securities", Feb. 15, 2008; *see also* Speech by Erik R. Sirri, Director of Trading and Markets, SEC, to the 2008 Bond Attorney's Workshop of the National Association of Bond Lawyers, September 17, 2008 (noting concern about "damage the liquidity freeze up in [auction rate securities] has caused to investor confidence in general"). Also, in 2008 the Federal Reserve had to intervene directly into the commercial paper market in order to prevent a freeze up in that market from causing a "run" on the entire financial system. *See* New York Times, "Fed Announces Plan to Buy Short-Term Debt", Oct. 7, 2008.

5 On the afternoon of "Black Monday", October 19, 1987, rumors that the NYSE would be closed on the following day prompted "further sales as traders reportedly worried that a market close would lock them into their existing positions." Mark Carlson, Federal Reserve Board of Governors, "A Brief History of the 1987 Stock Market Crash with a Discussion of the Federal Reserve Response", citing the Wall Street Journal, "Managing a Crisis", Oct. 21, 1987.

volatility serves to bolster investor confidence. The deep liquidity provided by market makers also serves as the first line of defense against market manipulation, as a would-be manipulator would have to transact thousands or tens of thousands of shares to move the price by even a penny. We believe it is no coincidence that the majority of market manipulation cases prosecuted by the Commission involve thinly-traded securities lacking competitive market makers. As the Commission is well aware, the prevention of (even more so than the prosecution of) market manipulation is a crucial component of investor confidence.

Today's market makers often transact across multiple products and asset classes, preventing discontinuous or disconnected price discovery among cash equities, futures, Exchange Traded Funds ("ETFs"), and other derivatives markets. A market maker's ability to efficiently harmonize pricing across disparate markets, and thereby extend the depth of liquidity in any one market to other markets, substantially mitigates the systemic risk endemic to extraordinary market volatility. Moreover, synchronizing and consolidating price discovery across these disparate markets is critical to investor confidence.[6] As few individual investors have direct access to or the requisite knowledge to transact in the myriad of derivatives markets, it is important that market makers maintain consistent pricing across asset classes to ensure that market professionals do not have unfair access to alternative markets and pricing. Investor confidence relies upon true price discovery, even if the investor is unable to access each and every market.

Finally, it is important to note that, for purposes of the Commission's short sale rules, what defines a market maker is not and should not be an arbitrarily awarded registration or designation, but rather bona fide market making activity. As noted in the Commission's October 17, 2008, Amendments to Regulation SHO, the determination of whether or not selected activity constitutes bona-fide market making should be based on the facts and circumstances of the activity itself.[7] While in different market contexts different factors may be relevant, we believe – based on the discussion in the October 17 Amendments and our own experience and recent analysis of liquidity provision in today's electronic markets – that the factors indicative of bona fide market making include whether or not the market participant:

* Displays quotes on publicly accessible exchanges or ATSs;

* Quotes on a continuous and regular basis;

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6 One of the factors that exacerbated the 1987 market crash was the "de-linkage" of the cash and futures markets in which there was a significant deviation in the price of S&P 500 index futures and the actual S&P 500 stocks, sowing confusion and severely undermining confidence in both markets. *See* Report of the Presidential Task Force on Market Practices (the "Brady Report") at 59 (Jan. 8, 1988) (noting that the failure of "market segments to perform as one market contributed to the violence of the market break in October 1987").

7 Release No. 34-58775 at 32 (Oct. 14, 2008), 73 Fed. Reg. 61690 at 61699 (Oct. 17, 2008) (the "October 17 Amendments").

* Quotes both sides of the market generally at or near the market, or near fair value (e.g. Net Asset Value for ETFs, underlying value for depository receipts, etc.), on a regular basis;

* Incurs economic or market risk (i.e. is not solely acting as a riskless principal);

* Provides liquidity to a security's market on a regular basis;

* Takes the other side of trades when there are short-term buy-and-sell-side imbalances;

* Quotes multiple price points, preventing excess volatility through depth of liquidity; and/or

* Trades without long or short bias, in a pattern that demonstrates minimal net economic exposure in a particular security (e.g. buys and sells in roughly comparable amounts; or purchases of securities, hedged with other securities or security derivatives).

We note that these factors are not an exclusive list, and that bona fide market making activity may exhibit some or all of the characteristics above and should be evaluated on a facts and circumstances basis.[8] Most importantly, the Commission has clearly described activities that do not qualify as bona fide market making (e.g. "activity that is related to speculative selling strategies or investment purposes of the broker-dealer"), setting clear and narrowly-defined boundaries.[9] In the same spirit, we strongly support the Commission's efforts to distinguish between bona fide market making activity and market making firms. We believe that the activity itself should be protected through proper exemptions, but that entire firms should not operate under such exemptions merely based on a registration or occasional market making activity.

B. Impact of the Proposed Amendments on Market Making

The Proposed Amendments will impact the activities of market makers in a wide variety of market conditions. Although it has been posited that activities conducted in "advancing markets" will be spared, we do not believe this will be the case. First, it is our experience that even markets generally trending upward do not uniformly move in one direction,

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8 The list of factors is based on the list in the October 17 Amendments (73 Fed. Reg. at 61698-99), but modified based on our own experience and analysis of liquidity provision in today's electronic markets.

9 October 17 Amendments, 73 Fed. Reg. at 61699.

and thus the term "advancing market" is illusory in the context of market microstructure. Second, no market participant can accurately predict whether or not the market will be advancing or declining in the next second or minute. Therefore, under the Proposed Amendments, a market participant would not be able to predict whether the "firm" quotation displayed in the market would truly be actionable one second later – the validity of the quote would not depend on the price, but on external factors that are unknowable *a priori*. For example, if a market making firm was at that instant short and saw a bid in the market, whether or not the market maker could actually transact with that bid would depend on the vagaries of other market participants' quotations, a potentially ephemeral situation that can change from millisecond to millisecond, and even when an order is "in transit" to the exchange to be executed.[10] While the market maker might have been able to transact on the bid one second ago, a flicker in the National Best Bid of Offer ("NBBO") in the interim could have subsequently rendered that bid untouchable unless and until the NBBO flickers back to its previous state.

This uncertainty has a profound impact on market making. As market makers continuously stand ready to buy or sell securities and assume the related risk of these positions, market makers must carefully analyze opportunities to hedge their risk at all times. However, if a market maker can no longer trust that the quotation currently displayed may be actionable when it needs to hedge the risk exposure, the market maker by default assumes significantly more economic risk and compensates for this with a wider bid/offer spread.[11] In this way, individual investors are made to assume the incremental cost of the additional risk the market maker is forced to bear.[12] Additionally, market makers may also seek to mitigate this additional risk through reducing the size of the quotations, resulting in increased volatility and trading costs. In some cases, the market maker may find it economically infeasible to assume the additional risk created by this inefficiency, and may simply withdraw entirely.

Moreover, if additional short sale restrictions are imposed after a particular security has declined in value by a significant percentage, the potential impact may be worse. If a security has suffered a significant decline, additional constraints that affect the ability of market makers to provide high-quality markets may actually hasten the decline, as decreased size and wider spreads will further undermine already battered investor confidence in the security. Further, should market makers be unable to fulfill their role due to an outright ban on short sales,

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10 A troubling side-effect of this is that an investor who entered the limit order to buy may not be able to execute his or her order even though there is a willing counterparty, frustrating their effort to purchase securities.

11 We note that market makers frequently hedge their risk exposure through transactions in related but distinct securities, and thus a "circuit breaker" approach does not necessarily limit the scope of the restrictions to a single security – a halt in a security used as a hedge for market making activity may thus impact markets in many securities.

12 The Office of Economic Analysis report on the September 2008 short selling restrictions supports this conclusion, noting that "restricting short sales that provide liquidity or react to price overreaction might result in higher transaction costs and higher volatility." Office of Economic Analysis, Memorandum Re: Analysis of Short Selling Activity during the First Weeks of September 2008 at 1 (December 16, 2008).

the absence of their liquidity will increase the security's exposure to manipulative activity, and the disappearance of quotes may serve to trigger the very "run" on the bank that the Proposed Amendments are intended to prevent.

Finally, it is important to note that the widening of bid/offer spreads and reduction of liquidity in the public markets is likely to accelerate the flight of institutional and professional trading volume to "dark pools" and broker "internalization" facilities. Regulation NMS has been a potent force in consolidating price discovery and liquidity in fair and transparent public markets. As volume and competition increased in these markets, it became increasingly difficult for brokers to "internalize" customers orders due to the best execution requirements of Regulation NMS, and even more volume migrated to the public markets. However, a widening of bid/offer spreads and decrease in liquidity provided by professional market makers could reverse the consolidation of liquidity in the public markets, permitting some brokers once again to take advantage of decreased competition in price discovery and offer substantially inferior (but still technically legal) internalization prices to their customers.

In sum, we believe that if any of the Proposed Amendements were adopted and did not include the proper provisions in support of bona fide market making, it will result in impaired price discovery, wider bid-offer spreads (at a greater cost to investors), less overall liquidity, and an increase in the flight of liquidity from the public markets to dark pools and internalization facilities – a series of consequences that individually and jointly will severely undermine investor confidence.

IV. <u>Recommendations</u>

In light of the concerns described above, we urge the Commission to review fully the implications of the Proposed Amendments and determine what the most appropriate approach is to meet the stated goals of limiting the potential impact of speculative or directional short selling in declining markets, while concurrently maintaining the fair and orderly markets upon which investor confidence ultimately relies. EWT believes that the single most important issue for the Commission in this regard is not the mechanism by which short sale restrictions would be implemented, but rather that any such restrictions be narrowly tailored to avoid adversely affecting non-directional activities such as market making and risk mitigating hedging.[13] Such discretion will protect that the liquidity and integrity of our markets, upon which investor confidence depends.

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13 Although we believe that each of the proposed implementation mechanisms have certain disadvantages, we believe that the approach with the fewest adverse consequences for the market would be the proposed modified uptick rule based on current bid data. The uptick rule based on last sale data is unworkable in today's decentralized markets, and the circuit-breaker approaches may exacerbate market dislocations by suddenly and unexpectedly altering the regulatory regime and liquidity characteristics of a particular security, precisely when it is under duress. Regardless, the myriad of permutations makes succinct analysis

We respectfully request that the Commission consider, in particular, each of the modifications we suggest below, which we believe preserve the central objectives advanced by the Commission and which we have ranked in order of importance:

(1) The Commission should implement an exemption from any short sale price restrictions for bona fide market making activity. This targeted exemption would permit market makers to continue to provide competitively priced liquidity, ensuring functioning markets, the cornerstone of investor confidence.

(2) The Commission should implement an exemption from any short sale price restrictions for activity that results in no net short economic exposure for a particular issuer (e.g. an equities position hedged with equivalent futures, an ETF position hedged with the components of the ETF, a depository receipt hedged with the underlying security). This would permit a very narrow range of risk mitigating trades while protecting the issuer from any true directional pressure. Risk-mitigating hedging is a key stabilizer in turbulent markets, and restricting the ability to reduce one's risk would be a serious blow to investor confidence. We note that both the United Kingdom's Financial Services Authority and the Netherlands' Authority for the Financial Markets adopted this approach in their recent short selling restrictions as well.

(3) The Commission should implement an exemption for securities based on broadly-defined indices, such as ETFs and closed-end funds. By definition, these instruments do not reflect upon a single issuer; moreover, they are frequently used in risk mitigation as a hedge for unwanted risk. As mentioned above, the ability to reduce one's risk is a critical component of investor confidence.

(4) The Commission should implement the proposed "broker dealer provision" as defined in the Proposed Modified Uptick Rule (201(c)), which permits the broker dealer to verify compliance with the bid test on order submission. Without this exemption, an exchange receiving lagged or stale market data from another exchange may incorrectly refuse to execute a directed order, creating directly contradictory requirements between Regulation NMS (which requires routing the order to the exchange) and Regulation SHO (which requires the exchange to reject the order) for the broker dealer.

Finally, we hope that any implementation of the Proposed Amendments will include a pilot test similar to the test employed in 2004, so that an accurate measurement of the costs and benefits of these actions may be conducted.

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difficult, and we hope there will be additional opportunity to comment once a single approach is selected but prior to adoption.

More generally, as market sentiment eases, we urge the Commission to maintain its broad perspective in evaluating Regulation SHO, and to continue its extensive monitoring of short sales and other market data. The evolution of Regulation SHO over the past several years has generally reflected the Commission's balanced and thoughtful approach to the complex issues raised by short sales. We believe that a careful targeting of its provisions, rather than sweeping market restrictions that risk substantial unintended consequences, offers the greatest protection for improved future market stability.

EWT appreciates the opportunity to comment on the Proposed Amendments and would be pleased to discuss any of the comments or recommendations in this letter with the Commission staff in more detail. If you have any questions, please do not hesitate to contact the undersigned at (310) 651-9746.

Sincerely,

Peter Kovac
Chief Operating Officer and
Financial and Operations Principal

cc: Mary L. Schapiro, Chairman
Kathleen L. Casey, Commissioner
Elisse B. Walter, Commissioner
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