June 23, 2009

Elizabeth Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

RE: SEC Proposal on Short Sale Price Test

Dear Ms. Murphy:

Direct Edge Holdings LLC[1] ("Direct Edge") appreciates the opportunity to offer its views respecting the amendments to Regulation SHO proposed by the Commission (the "Proposals"). Direct Edge's first comment letter respecting the anticipated Proposals, dated March 30, 2009, set forth our view that the appropriate response to abusive short selling was to: (1) target abusive conduct; (2) strengthen existing locate, borrow, and delivery regulations; and (3) improve short interest disclosure requirements and extend such requirements to synthetic short products, including credit default swaps. Having reviewed the Proposals following their release on April 10, 2009,[2] we continue in the view that overly broad restrictions on trading activity are not an appropriate response to marketplace concerns regarding abusive short selling.

Should the Commission decide to adopt one of the Proposals (Uptick, Modified Uptick, Circuit Breaker Uptick, Circuit Breaker Modified Uptick, or Circuit Breaker Trading Halt) or a variation thereof, implementation concerns should be paramount. We urge the Commission to consider the most efficient utilization of technical, compliance and enforcement resources to mitigate the costs to the securities industry. Other anticipated near-term regulatory changes, specifically with respect to locate and pre-borrow requirements, may also require significant changes to broker dealer systems and pre-execution processes. We caution against assuming that different aspects of short sale regulation are disconnected from a systems and process perspective. Given that we are in a period of increasing regulation in the financial services industry, proactive identification of efficiencies will enable more rapid implementation of future system and process changes while minimizing strain on their supporting infrastructure.

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[1] Direct Edge currently operates the third-largest stock market for the trading of U.S. equity securities, behind only NYSE Euronext and NASDAQ OMX. More information about Direct Edge is available at www.directedge.com.

[2] Exchange Act Release No. 34-59748 (April 10, 2009); 74 F.R. 18042 (April 20, 2009) ("First Release").

Price Tests

We believe that while the Uptick, Modified Uptick, Circuit Breaker Uptick and Circuit Breaker Modified Uptick tests (the "Price Tests") may offer the illusory comfort of familiarity, they would be difficult to implement and would hamper market efficiency. The Uptick or last sale price test poses insurmountable sequencing issues due to the potential for a ninety-second lag time with respect to trade reporting. Such sequencing issues make the ability to sell short a security as dependent on the actual price direction of a security as the sequence that the sales for that security were reported.

With regards to a Modified Uptick or national best bid ("NBB") price test, similar sequencing issues exist unless all broker dealers are forced to use a unitary Securities Information Processor ("SIP") data feed. Mandating use of the SIP feed would be disproportionately onerous to market participants who utilize direct market data feeds to ensure the most current market data and would need to reconcile disparate market data in their execution management and order routing systems. Even utilizing a unitary data feed would be problematic, however, given the "flickering" that occurs whenever the NBB changes multiple times within a second. The existence of "flickering" would hinder a market participant's ability to comply with any of the Price Tests and this is not an issue that can be solved for at the market participant level.

Furthermore, and more importantly, Price Tests represent a data intensive form of regulation. This would mean a significant expansion of the data retention requirements of broker dealers in the form of "snapped quotes" and more regulatory staff would be required to review such data. Even if the SIP were to publish a continuous directional indicator for each security throughout the day to avoid the duplication of effort by each broker dealer, the data storage requirements would rival those of Regulation NMS. In addition, a more data intensive form of regulation would expose brokers to more technical violations and strain compliance and enforcement resources.

Circuit Breaker

From a market liquidity and efficiency perspective, applying short sale restrictions upon the triggering of a circuit breaker is preferable to applying a short sale restriction in all circumstances. Additionally, since the Commission is considering the Proposals in response to questions about "rapid and steep declines in the prices of securities" and the resulting loss of investor confidence,[3] a circuit breaker test would ensure that these liquidity restrictions would be targeted in their application to the types of circumstances that provoked the consideration of the Proposals. We believe that the triggering of a circuit breaker on a 10% intraday decline in the price of a particular equity security is a baseline minimum for all equity securities, but that a higher intraday price decline

[3] First Release at 18048.

threshold might be warranted based on an individual security's share price, volume, market capitalization, and stock volatility characteristics.

We also believe that the ability to leverage the SIP data feed to determine whether a circuit breaker threshold level has been triggered would limit needless duplication of effort. This could be accomplished by requiring the primary listing exchange to communicate the triggering of a circuit breaker event to the SIP, who would then redistribute such information to the market. Given that the SIP feed would only be relied on to determine a maximum of one threshold trigger event per security per day, it would not pose the same system challenges as would the determination of bid direction on a real-time, pre-execution basis for short sales.

As noted in our first comment letter, the application of circuit breakers could increase selling pressure as the value of the affected security approaches the relevant price level[4] and thus, create a "magnet" effect. While some studies have been cited as evidence that no "magnet" effect exists,[5] such studies were conducted in markets dissimilar from the highly automated markets currently existing in the United States. Therefore, a pilot test should be conducted to enable the Commission to study the effects of a circuit breaker approach on market volatility, price efficiency, and liquidity.

Circuit Breaker Trading Halt

While the Circuit Breaker Trading Halt is the least costly of the Proposals to implement, the Circuit Breaker Trading Halt would appear to be the most draconian from a market liquidity and efficiency perspective absent liberal exceptions, as it would have the effect of restricting all liquidity that short sellers provide to the equities marketplace while triggered. We believe it essential, therefore, that should the Circuit Breaker Trading Halt be adopted by the Commission, that such regulation: (1) incorporate appropriate exceptions, such as the exceptions proposed in the Commission's release[6] and exceptions

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[4] Letter to the Honorable Mary Schapiro, Chairman, SEC, from Eric Hess on behalf of Direct Edge Holdings, LLC (March 30, 2009) at p.3.

[5] Letter to the Honorable Mary Schapiro, Chairman, SEC, from Dan Mathisson on behalf of Credit Suisse Securities (USA), LLC. (March 30, 2009) at p.5 (citing the following studies studying the existence of a possible magnet effect: *Abad and Pascual (2005)* studying the Spanish stock exchange; *Chan, et al (2005)* studying the Kula Lumpur Stock Exchange; *Hall and Korfman (2001)* studying five agriculture futures contracts; *Berkman and Steenbeek (1998)* studying futures contracts on the Osaka Securities Exchange; *Arak and Cook (1997)* studying treasury bond futures).

[6] First Release at 18067-18068 (setting forth the following proposed exceptions for a circuit breaker halt rule: (1) registered market makers, block positions and other market makers obligated to quote in the over-the-counter market, if they are selling short as part of bona fide market making in such security; (2) market makers effecting short sales as part of bona fide market making and hedging activity related directly to bona fide market making in derivatives; (3) short sales that occur as a result of automatic exercise or assignment of an equity option held before a circuit breaker on a particularly security is triggered; (4) short sales that occur as a result of the expiration of futures contracts held before a circuit breaker is triggered in

for "benchmark trades" (such as volume weighted average price orders), riskless principal trades and arbitrage (for indices, ETFs and ETNs); (2) incorporate circuit breaker triggers of no less than ten percent per security in a given trading day, with higher thresholds based on price, volume, capitalization and volatility characteristics; and (3) be limited in duration to the end of the trading day during which the halt occurred.

Passive Bid Test

Several exchanges have proposed a "passive bid test" to be deployed upon the triggering of the circuit breaker threshold.[7] Under such a test, the execution of a short sale could occur only above the national best bid at the time of initiation and only on a passive basis (i.e., short sales cannot hit bids). This proposal does not suffer from the same sequencing issues as the Price Tests, as the short seller creates the "up bid." This makes it a preferable alternative to the Price Tests. We also believe that the passive bid test is preferable to the Circuit Breaker Trading Halt because it would allow all short sellers to continue to add liquidity to the marketplace in the impacted security. Further, the passive bid test would be less dependent on exceptions than the Circuit Breaker Trading Halt to make it a viable alternative and thus, it would be simpler to understand and enforce.

Exemptions

The adoption of the appropriate exceptions is the key element to our qualified support of any liquidity restriction on short sales, specifically with regards to bona fide market making across asset classes (including options and futures) as the short selling activity of market makers facilitates buyer interest in the marketplace and is clearly not the kind of activity that these Proposals are designed to target. Therefore, any exception for "bona fide market making" should adopt the definition noted in the proposed amendment for the Circuit Breaker Trading Halt proposal, namely that such market making occurs when a broker-dealer "deals on a regular basis with other broker-dealers, actively buying and selling the subject security as well as regularly and continuously placing quotations in a quotation medium on both the bid and ask side of the market."[8]

While not referred to specifically above, it should be noted that short positions taken by professional investors, particularly hedge funds, are more often than not hedged by long positions. This type of long-short activity is beneficial to the market. As is the case with respect to market making, this activity makes the market more efficient and liquid,

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a particular security; (5) short sales that occur as a result of assignment to call writers upon exercise; and (6) owned Rule 144 securities.)

[7] Letter to the Honorable Mary Schapiro, SEC, from the United National Securities Exchanges (March 24, 2009).

[8] First Release at 18067.

resulting in narrower spreads, greater quote depth, and better pricing for investors. Whatever approach is adopted by the Commission, serious consideration need be given to the impact that the resulting regulation would have on these beneficial strategies and the unintended consequences of restricting this activity.

Pre Borrow

If the Commission considers the imposition of a pre-borrow requirement on certain short sales, whether in connection with an alternative circuit breaker proposal[9] or otherwise, it should consider the host of issues that will arise surrounding the delivery of securities to a customer account prior to the effectuation of a short sale, such as the cost of locking up securities for a transaction that may never take place and, if it does, will not settle for three days. We therefore urge the Commission to carefully examine stock loan, borrow, and delivery requirements in light of the entire stock lending process and to review the definition of what constitutes a "pre-borrow" in the interest of minimizing the inefficient use of capital associated therewith. Alternatively, should the Commission determine that existing locate regulations need be strengthened, we recommend that the Commission consider mechanisms to improve trade date validation of locates for shorted securities. This would have the added benefit of causing locates to become a more reliable indicator of the source of delivery and thus, increase their use in back end securities delivery processes.

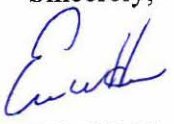
Conclusion

Direct Edge appreciates the efforts of the Commission to engage in a fully informed discussion of the Proposals. While we do not feel that the adoption of the Proposals is warranted, if the Commission does determine that it is appropriate to pursue adoption of the Proposals, we believe that the Passive Bid Test represents the best alternative, subject to the conditions set forth herein. Under all circumstances, we believe that the implementation of any short sale regulation should be considered in tandem with any changes that the Commission will be seeking to make to stock loan locate, borrow and delivery requirements. Lastly, in all circumstances, we believe that any regulation should be adopted on a pilot basis to assess its marketplace effects.

[9] Letter to the Honorable Mary Schapiro, SEC, from Peter J. Driscoll, Chairman and John C. Giesea, President & CEO, Security Traders Association (May 4, 2009).

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

Sincerely,



Eric W. Hess
General Counsel

cc: Hon. Mary Schapiro, Chairman
Hon. Luis A. Aguilar, Commissioner
Hon. Kathleen L. Casey, Commissioner
Hon. Troy A. Paredes, Commissioner
Hon. Elisse B. Walter, Commissioner
James Brigagliano, Co-Acting Director of Trading and Markets