September 21, 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:

This letter contains the comments of three leading investment management firms, Citadel Investment Group, the D. E. Shaw group, and Renaissance Technologies (collectively, the "Managers"), on the alternative uptick rule as proposed by the Securities and Exchange Commission ("SEC" or the "Commission") on August 17, 2009.[1] We appreciate having the opportunity to provide our views.

We submitted a letter to the Commission on June 19, 2009,[2] responding to the SEC's initial request for comment on whether short sale price restrictions would help promote market stability and restore investor confidence.[3] The Managers' June 2009 Letter described our many concerns, based on our experience and a substantial body of empirical data, about potential new short sale restrictions. This letter is intended to renew and supplement our earlier comments and respond to specific questions raised by the SEC in the Alternative Uptick Proposing Release.

Our principal comment is that the proposed alternative uptick rule, like the April Proposals, would not produce the benefits or meet the goals the Commission identified. In fact, because the proposed alternative uptick rule is more restrictive of short sales than the principal alternatives discussed in the April Proposals, it would lead to greater disruption of legitimate trading activity and even greater market costs (such as reduced liquidity, wider spreads, and increased market volatility) and would do so without providing offsetting benefits. The SEC already has powerful tools to combat manipulative behavior and problematic naked short sales.[4] For these reasons, the Managers urge the SEC not to adopt any of the proposed short sale restrictions, including the alternative uptick rule, which is the most restrictive proposal to date.

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1 *See* Securities Exchange Act Rel. No. 60509 (Aug. 17, 2009), 74 Fed. Reg. 42033 (Aug. 20, 2009) (the "Alternative Uptick Proposing Release").

2 *See* Letter from John C. Nagel, Citadel Investment Group, L.L.C., *et al.* (June 19, 2009), *available at* http://www.sec.gov/comments/s7-08-09/s70809-3796.pdf (the "Managers' June 2009 Letter").

3 *See* Securities Exchange Act Rel. No. 59748 (Apr. 10, 2009), 74 Fed. Reg. 18042 (Apr. 20, 2009) (the "April Proposals").

4 *See, e.g.,* Securities Exchange Act Section 9; Rule 10b-5; Rule 10b-21; Rule 204.

If the Commission nonetheless concludes that adopting an alternative uptick rule or other form of short sale price restriction is necessary and appropriate, we believe the rule should be narrowly tailored to minimize adverse effects on the trading markets. At the end of this letter and in the Managers' June 2009 Letter, we mention some of the features a rule should include. In particular, any form of alternative uptick rule or price restriction on short sales should be implemented through a market center policies and procedures approach (that is, by requiring market centers to have policies and procedures reasonably designed to prevent the execution of short sales at impermissible prices) rather than through a strict prohibition on all market participants.

The proposed alternative uptick rule would significantly limit short sales and would do so more than any price restriction proposed thus far and more than former NASD Rule 3350 and Rule 10a-1 under the Securities Exchange Act. It would allow short sales to be entered only at a price above the current national best bid. An order to sell short would need to be entered as a limit order and could be executed only when a new buyer entered the market at a price higher than the then-current national best bid. For example, if the national best bid in a stock was $10.00, the potential short seller's lowest possible offer would be $10.01.

Like the former bid-based price restriction (NASD Rule 3350) and the April Proposals, the proposed alternative uptick rule would prevent short sales at a price equal to the best bid in a downward trending market. However, the proposed alternative uptick rule would be more restrictive than the other rules because it would prohibit short sale orders from being entered at a price equal to the best bid even in an upward trending market. The introduction of such a restriction would be unprecedented. Indeed, it is difficult to understand the need for such a restriction in an upward trending market given that short sales help to ameliorate upward price manipulations and that the risk of short sale manipulations decreases when the market is rising. Furthermore, the introduction of a rule that restricts short sale orders in an upward trending market would be contrary to the Commission's initial objectives for a short sale price restriction. The April Proposals were designed to allow relatively unrestricted short selling in an advancing market but to prevent short selling from being used as a tool for driving the market down or from being used to accelerate a declining market by exhausting all remaining bids at one price level.[5]

The proposed alternative uptick rule also would delay short sale executions and possibly deter short sellers from entering orders in an upward trending or static market as well as in a downward trending market. In the example above, a potential long seller could enter an offer at $10.00 to obtain an immediate execution, but a short seller would need to enter a passive limit order at a price of at least $10.01. Until a buyer is willing to pay a price higher than the national best bid (by entering a market order or a marketable limit order to buy), long sellers entering market orders would in every case have their

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5 *See* Securities Exchange Act Rel. No. 59748 (Apr. 10, 2009), 74 Fed. Reg. 18042, 18091 (Apr. 20, 2009).

trades executed before any pending short sale order. As a result, in a neutral or declining market, short sales may never be executed, leading, as a practical matter, to the same effect as an outright ban on short selling.[6] In addition, even in an upward trending market, the time delay in achieving executions and the risks associated with displaying passive limit orders[7] are likely to deter many potential short sellers from entering the markets, especially short sellers with orders of non-negligible size. An alternative uptick rule therefore would adversely affect market liquidity and price discovery, both of which are essential to orderly markets.[8]

Another possible consequence of the alternative uptick rule could be that buyers, including retail investors, would often need to pay artificially high prices to obtain execution. This would occur because non-marketable limit orders to buy could not be filled by short sellers, and these missed execution opportunities would require many buyers to pay a higher price to get filled. For example, assume that a long-term retail investor decides to enter a limit order to buy 1,000 shares at $10.00 when the national best bid is $10.00 and the national best offer is $10.05. An alternative uptick rule would prevent potential short sellers from providing liquidity to the buyer at $10.00. If no long seller decides to sell at $10.00 and no short seller is willing to take the risk of exposing an order to sell at $10.01, the buyer would need to enter a market order and pay an additional $.05 per share to obtain execution.[9] In this example, the alternative uptick rule would increase the buyer's cost by $50 ($.05 per share times 1,000 shares). The price

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6 The Managers' June 2009 Letter describes the adverse market effects that occurred when a short sale ban was imposed in September 2008.

7 Limit orders for NMS stocks are generally subject to display requirements, and thus short sale orders under the alternative uptick rule proposal could be subject to the risk that long sellers would use the information in the orders to their advantage and front-run or pick off the orders. *See* 17 C.F.R. § 242.604(a). Although a customer may choose not to display an order, *id.* § 604(b)(2), an order that is not displayed might be subject to practical disadvantages, such as delayed execution.

8 As discussed in the Managers' June 2009 Letter, a short sale restriction will tend to reduce liquidity on both the long and the short sides of the market because many investors and market participants use short selling as part of a hedging strategy and because short sellers provide a willing counterparty for buying interest, thereby allowing buyers to complete transactions. Some commentators have implied that short selling in some instances drains liquidity from the market, rather than contributing liquidity. We strongly disagree with any such assertion. It is a widely accepted fact that by standing willing to sell, short sellers are a valuable source of liquidity. *See, e.g.*, Securities Exchange Act Rel. No. 59748 (Apr. 10, 2009), 74 Fed. Reg. 18042, 18044 (Apr. 20, 2009) ("Short sales effected in the market add to the selling interest of stock available to purchasers and reduce the risk that the price paid by investors is artificially high because of a temporary imbalance between buying and selling interest.").

9 Even if a short seller were willing to take the risk of entering an order to sell at $10.01, as short sellers might be willing to do some but not all of the time, the buyer would still need to pay an additional $.01 per share to trade with the short seller.

increase would be even larger if the market rallied and the best offer increased while the buyer was trying to obtain a fill at $10.00 per share. When this effect is multiplied across a substantial percentage of transactions that occur in the securities markets each day, the total cost of an alternative uptick rule could be enormous.

The Commission suggested that the primary reason for seeking comment on the proposed alternative uptick rule was that such a rule could be less costly to implement than the April Proposals. Although market centers would not be required to monitor the sequence of bids to determine whether a short sale is permissible and therefore might have somewhat lower implementation costs with the alternative uptick rule, any such cost savings would be realized by only market centers. Active traders using short sales as part of their hedging and investing strategies are not likely to realize any cost savings or benefit in terms of ease of implementation from this proposed rule. In fact, the costs associated with the implementation of the proposed alternative uptick rule are unlikely to differ from those associated with the other short sale restriction proposals. Even with a policies and procedures approach, in order to avoid rejection of short sale orders under an alternative uptick rule, programming would need to be implemented to anticipate changes in the national best bid between the time a short sale order is entered and the time it reaches the relevant market center. The Managers expect that it would require approximately the same amount of time and resources to develop order routing and message codes and to draft policies and procedures for any new short sale restriction other than an outright ban. One comment already in the Commission's file estimates that at least five months would be needed for market participants to prepare for an alternative uptick rule.[10]

In any event, a possible reduction in implementation costs would not justify adoption of the alternative uptick rule. Implementation would still involve costs, and they must be weighed in combination with the even more significant implicit and explicit costs to the day-to-day operation of the securities markets from such a drastic short sale restriction. The empirical data discussed in the Managers' June 2009 Letter and in many other comment letters show that short sale restrictions hinder the efficiency of the securities markets. That data apply with even more force to the more restrictive alternative uptick rule, as demonstrated in the example above. Furthermore, the data demonstrate that short sale restrictions are not effective in preventing accelerating declines in the market and therefore do not produce the benefits the Commission has identified. As a result, even if implementation of an alternative uptick rule would not be as costly as the adoption of other forms of a short sale restriction, a cost-benefit analysis still tilts decidedly toward costs given the totality of implementation expenses and adverse market effects.

Finally, if the Commission nonetheless concludes that adopting some form of an alternative uptick rule or other short sale price restriction is necessary and appropriate, we

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10 *See* letter from Dan Mathisson, Credit Suisse Securities (USA), LLC (June 16, 2009).

believe the rule should be narrowly tailored to minimize adverse effects on the trading markets. A short sale price restriction should have the following features, some of which were addressed in the Managers' June 2009 Letter:

- Any rule should take effect only when a circuit breaker for an individual stock has been triggered, indicating that market conditions for that security warrant the restriction. The Managers' June 2009 Letter described the concerns about a market-wide price test as compared to a stock-by-stock circuit breaker. We continue to believe that a stock-by-stock circuit breaker approach would be more narrowly tailored to address Commission concerns, particularly concerns about the effect of short selling in a market broadly subject to a severe downturn. In such a market, circuit breakers likely would be triggered for a large number of securities.

- Any rule should be implemented through a market center policies and procedures approach rather than a strict prohibition on all market participants. Requiring market centers to have policies and procedures reasonably designed to prevent the execution of short sales at impermissible prices would help promote compliance by all affected parties, distribute compliance and monitoring responsibility, allow flexibility to address inadvertent violations (thus likely resulting in fewer cancellations and trade breaks), and conserve the enforcement resources of agencies and other self-regulatory organizations.

- Because an alternative uptick rule would be extremely restrictive, the exemptions described in the Managers' June 2009 Letter should be part of any final rule.

CONCLUSION

Based on the Managers' experiences as significant capital market investors, we strongly urge the Commission not to adopt any new short sale restrictions. Our primary concern with the alternative uptick rule is that it is likely to function as an effective ban on short selling activity in all but the most favorable market conditions. Even in an upward trending market, short sale executions would be delayed or would not occur at all. Furthermore, an alternative uptick rule could cause buyers to pay artificially high prices.

If, however, the SEC believes it is necessary and appropriate to adopt a new short sale restriction, we urge it to impose a restriction that is more narrowly tailored than the proposed alternative uptick rule. In particular, the Managers believe that the circuit breaker with bid test, as described in the Managers' June 2009 Letter, would be the most appropriate alternative for achieving the Commission's objectives while causing the least market harm.

Thank you for the opportunity to comment.

Sincerely,

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Citadel Investment Group, L.L.C.

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

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