



September 21, 2009

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

RE: File No. S7-08-09  
SEC Supplemental Request for Comment Respecting  
Amendments to Regulation SHO

Dear Ms. Murphy:

This is Direct Edge Holdings LLC's<sup>1</sup> ("Direct Edge") third comment letter respecting the Commission's above referenced proposals regarding short sale price restrictive regulation (the "Proposals").<sup>2</sup> In Direct Edge's prior letters, we set forth our view that: (i) the benefits of short sale price restrictions would not exceed the costs to liquidity and price efficiency in the equities marketplace;<sup>3</sup> (2) the "Alternative Uptick Rule," referred to by Direct Edge as the "Passive Bid Test," was preferable to the Proposals; and (3) that the Alternative Uptick Rule should be implemented on a pilot basis in combination with a circuit breaker test.<sup>4</sup>

We note that the Commission has expressed concerns respecting the costs associated with the Alternative Uptick Rule in terms of the "potential impact of such a price test on quote depths, spread widths, market liquidity, execution and pricing inefficiencies."<sup>5</sup> For reasons further developed in the March 30<sup>th</sup> Letter, we share those concerns with respect to all proposals that impose short sale price restrictions but, nonetheless, if the Commission believes that it is necessary to impose such restrictions, the costs associated

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<sup>1</sup> Direct Edge currently operates the third-largest stock market for the trading of U.S. equity securities. More information about Direct Edge is available at [www.directedge.com](http://www.directedge.com).

<sup>2</sup> Exchange Act Release No. 34-59748 (April 10, 2009); 74 F.R. 18042 (April 20, 2009) ("First Release").

<sup>3</sup> Letter to the Honorable Mary Schapiro, Chairman, SEC, from Eric Hess on behalf of Direct Edge Holdings, LLC (March 30, 2009) (the "March 30<sup>th</sup> Letter").

<sup>4</sup> Letter to Ms. Elizabeth Murphy, Secretary, SEC, from Eric Hess on behalf of Direct Edge Holdings, LLC (June 23, 2009) (the "June 23<sup>rd</sup> Letter").

<sup>5</sup> Second Release at 42034.

with such restrictions can be minimized by imposing such restrictions only upon the triggering of properly defined circuit breakers and with the appropriate exemptions to such restrictions. Further, due to the lack of sufficient quantifiable, empirically-supported data supporting the benefits of short sale price restrictions, we urge the Commission to adopt any such rules on a one year pilot basis so that the benefits and costs of such a rule can be better identified and examined.

### **Circuit Breakers Will Minimize The Potential Negative Impact of Short Sale Price Restrictions**

In our June 23<sup>rd</sup> Letter, we urged the Commission to adopt circuit breakers in order to enable the Commission to narrowly target rapid and steep declines in equity prices and the resulting loss of investor confidence.<sup>6</sup> Circuit Breakers would have the added and perhaps more important benefits of preserving the liquidity and price efficiency that short sellers bring to rising and stable markets (whether moderately up or down) that are free of artificial price restrictions. In the context of such markets, short sellers add to the selling interest of stock available to buyers and reduce the risk that a buyer will pay an artificially high price due to a temporary lack of long sale orders in the marketplace. Direct Edge urges the Commission to carefully consider the significant benefits that short sellers bring to these markets. Failure to implement the circuit breaker approach will substantially diminish these benefits and the Commission itself has noted various studies conducted by its Office of Economic Analysis (“OEA”) and academics during 2004 that found the former short sale price restrictions limited short selling in up markets,<sup>7</sup> to the detriment of market liquidity and price efficiency. Furthermore, as the Commission has also pointed out that more recent studies conducted by OEA found that “short sale volume as a fraction of total volume was highest during periods of positive returns.”<sup>8</sup>

A properly constructed circuit breaker approach that accounts for stock volatility characteristics, as well as share price, volume and market capitalization would moderate some of the costs associated with the imposition of short sale price restrictions on hedging activity. As previously noted,<sup>9</sup> short positions taken by professional investors are more often than not hedged by long positions in other securities. Therefore, a natural consequence of restricting short selling is that purchases that are dependent on the ability to effect a short sale are also restricted. This point is even more important when markets are characterized by relative illiquidity.

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<sup>6</sup> June 23<sup>rd</sup> Letter at 2.

<sup>7</sup> First Release at 18046.

<sup>8</sup> First Release at 18049 (citing the OEA’s Analysis of a short sale price test using intraday quote and trade data, December 17, 2008).

<sup>9</sup> June 23<sup>rd</sup> Letter at 5.

### **Exemptions Must Be Carefully Considered**

The need for any particular exemption – particularly a market maker exemption – is contingent on the scope of the rule adopted. Assuming that the Alternative Uptick Test is adopted in combination with the circuit breaker approach, it *may* not be as critical for equities market making to have an exemption from the rule as equities market makers will generally post their offers one price increment above the National Best Bid (NBB) anyway. In a market characterized by the kind of decline that would trigger a circuit breaker, remaining above the NBB will tend to be the natural norm. If a circuit breaker approach is not adopted, however, then remaining one increment above the NBB will not be the default state in the context of a rising or even a stable market. In such markets, the NBB could move in the direction of a market maker's offer before the offer is matched. Clearly it does not serve the buyers' interest force them to pay more in such a case, as doing so would accelerate any existing upward momentum on the price of the underlying equity. Even if the Alternative Uptick Rule is adopted in conjunction with the circuit breaker approach, the price momentum of an equity could switch from a precipitous decline to a precipitous rise and the requirement to post one increment above the NBB would only accelerate upward momentum. For this reason, we believe that the lack of an equities market maker exemption in such scenarios should be examined with the benefit of pilot data.

While an equities market maker exception might not be as critical if the Alternative Uptick Rule is adopted in combination with a circuit breaker approach, such is not the case with respect to the bona fide hedging activity of market participants acting in their capacity as: (i) an options, ETF, futures, or convertible bond market maker; (ii) an options, ETF, futures or convertible bond facilitation desk; or (iii) a creator or redeemer of equities-linked derivatives instruments, such as ETFs ("Structured Product Liquidity Providers"). Such parties must have the ability to immediately execute a bona fide hedge against their structured product positions or else they will not be able to provide liquidity in such securities to the marketplace. Absent the certainty of execution that is paired with their facilitation of a structured product derivative risk, such participants would either curtail their provision of such liquidity to the marketplace or be forced to charge a significantly higher premium. It is important to remember that Structured Product Liquidity Providers have no motivation or reason to cause a decline in an equity's price. Their motivation is to contemporaneously offset the risk of the transaction associated with the respective structured product.

To minimize the risk of such an exemption creating in a net short result, we believe that the exemption can be limited in scope to the extent of the broker-dealer's long position or their exposure to a structured product transaction entered into with customers holding a long position in: (i) the underlying security, or (ii) any security that is convertible into or exchangeable for, or the value, exercise, payout or settlement of which is linked to the value of, the underlying security.

### **Technology Implementation Will Exceed Two Months Development and Does Not Take Into Account Structural Changes To Derivatives and ETF Businesses**

The Commission has requested input on whether a two month implementation timeline is adequate to incorporate the rule changes into the impacted systems. As a general matter, any regulation that requires a material change to be carried out by vendors to the financial services community requires a minimum implementation period of four months from the date the rules are enacted excluding, however, consideration of the downstream trading effects of such changes. Absent such effects, a four month minimum period allows for industry coordination, specification creation, development, quality testing and industry-wide testing, all related to implementing the rule requirements.

Adopting the Alternative Uptick Rule in conjunction with the circuit breaker approach would add approximately four to six weeks to the development process if the Alternative Uptick Rule could be implemented in the four month timeframe noted above due to the need for increased coordination between the Securities Information Processor (SIP) and the rest of the industry. We urge the Commission staff to consult with the relevant CTA and UTP Operating Committees for feedback before setting any implementation timelines.

As noted, the above timeline does not account for changes to trading strategies and their resultant effects that this rule will require. For example, if the foregoing hedging exemption is not permitted, systems and risk management processes of the impacted parties will need to be adapted. Thus, it is critical to determine not just how long it would take to program restrictions on short sales at or below the bid (with or without a circuit breaker), but how long it will take for an impacted Structured Product Liquidity Provider to modify its systems to account for the additional risk of not being able to hedge a long position at the bid simultaneously. If a trading desk cannot effect a short hedge simultaneously with assuming such exposure, then that desk will need to change their business strategy or model. Any implementation of the Alternative Uptick Rule will become more complicated if hedging restrictions are placed on bona fide Structured Product Liquidity Provider activity in the marketplace.

In short, if the Alternative Uptick Rule is to be implemented as quickly as possible, it must be implemented in such a way so as not to force such providers to substantially alter their systems and risk management practices.

### **Conclusion**

Direct Edge appreciates the efforts of the Commission to engage in a fully informed discussion and its willingness to reconsider the Proposals in light of the responses to their Proposals. While we do not believe that any short sale price restriction is warranted at

this time, we believe that the Alternative Uptick Rule represents the best alternative for the reasons set forth in our June 23<sup>rd</sup> Letter, subject to the conditions set forth therein and herein. Under all circumstances, we believe that the implementation of any short sale regulation should be considered in light of other Regulation SHO related changes and guidance that the Commission has made or is seeking to make, including through its Responses To Frequently Asked Questions Concerning Regulation SHO<sup>10</sup> and reform of the securities lending market generally. Lastly, we believe that any rulemaking in this area should be adopted on a pilot basis to assess its marketplace effects.

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

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<sup>10</sup> <http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm>