HUDSON RIVER TRADING LLC

September 21, 2009

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

Re: Amendments to Regulation SHO, Release No. 34-60509, File No. S7-08-09

Dear Ms. Murphy,

I. Introduction

Hudson River Trading LLC ("Hudson River Trading") appreciates the opportunity to comment on the above referenced proposal to amend Regulation SHO (the "Proposal"). Hudson River Trading is a quantitative trading firm that develops automated trading strategies that provide liquidity and facilitate price discovery on exchanges and ATSs. We recognize and appreciate the Securities and Exchange Commission's ("Commission") decision to reexamine short sale price tests in light of the volatile market conditions of 2008. We commend the Commission and its staff for allowing sufficient time for additional research and comments on the Proposal to ensure that any rule change is in the best interest of investors and market quality. Furthermore, we commend the Commission on the actions it has already taken to prevent manipulative and "naked" short selling and to make short sale data more transparent. Hudson River Trading urges the Commission to ensure that any new rule "will promote efficiency, competition, and capital formation."[1]

Hudson River Trading opposes the reinstatement of any short sale price tests, as research suggests that price tests degrade market quality for investors and are ineffective in combating abusive short selling. While we appreciate the Commission's decision to reexamine short sale price tests, the results of the research conducted on short selling during the volatile market conditions of 2008 confirm the Commission's decision to eliminate price tests. If the Commission believes that some form of prohibition against short selling may be justified in some extreme circumstances, we believe it should adopt the Alternative Uptick Rule in conjunction with a circuit breaker. We believe that any restriction against short sales should be sufficiently focused, so as to not require extensive exceptions to make the rule workable.

[1] 15 U.S.C. 78c(f).

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II. Short Sale Price Tests Degrade Market Quality

Short selling enhances market quality by providing liquidity, aiding in price discovery and decreasing volatility. Short selling enhances market efficiency and ensures that investors have access to fair prices that accurately reflect all public information. Boehmer and Wu found that:

> Short Selling is associated with more efficient pricing in the sense that prices appear to be closer to efficient or fundamental values when short sellers are more active. In contrast, we find no evidence that hints at price destabilizing or manipulative trading by short sellers...Our results have important implications for recent regulatory actions that restrict short selling. Specifically, restrictions on short selling constrain a particularly informed type of trading and are likely to hamper the price-discovery function of equity markets.[2]

Efficient price discovery benefits investors as buyers of securities should not be forced to pay inflated prices for securities because a price test restricts negative information from being reflected in the security's price. Short selling also provides liquidity to the markets and decreases intraday volatility.[3] Reintroducing a price test is likely to degrade market quality as these beneficial aspects of short selling will be restricted. Academic researchers who studied market quality during the temporary short sale ban found that "Stocks subject to the ban suffered a severe degradation in market quality, as measured by spreads, price impacts, and intraday volatility."[4]

III. Short Sale Price Tests Are Ineffective in Protecting the Interests of Investors

The Commission has noted on several occasions the benefits of legitimate short selling, including in the instant Proposal. We believe that the goal of the Commission is to target potentially manipulative or abusive short selling that could be used as a tool to drive down a stock's price or to accelerate the decline in a stock's price. However, the Office of Economic Analysis ("OEA"), in its "Analysis of Short Selling Activity during the First Week of September 2008," found that:

> Our results are inconsistent with the notion that, on a regular basis, episodes of extreme negative returns are the result of short selling activity. On average, short sale volume as a fraction of total volume is higher for periods of positive returns than for periods of negative returns. In addition, the average price aggressiveness of sellers who own the stock is higher than what is observed for short sellers.[5]

In addition, the OEA finds that "In general, during periods of extreme negative returns, the sell pressure is more intense for long trades indicating that short sales put less pressure on prices than other sales

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[2] Boehmer, Ekkehart, and Wu, Julie, *Short Selling and the Informational Efficiency of Prices* (Jan. 8, 2009)

[3] See Office of Economic Analysis, *Analysis of Short Selling Activity during the First Weeks of September 2008* (Dec. 16, 2008) available at http://www.sec.gov/comments/s7-08-09/s70809-369.pdf.

[4] Boehmer, Ekkehart, Jones, Charles M., and Zhang, Xiaoyan, *Shackling Short Sellers: The 2008 Shorting Ban* (June 1, 2009) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1412844.

[5] Office of Economic Analysis, *Analysis of Short Selling Activity during the First Weeks of September 2008* (Dec. 16, 2008) available at http://www.sec.gov/comments/s7-08-09/s70809-369.pdf.

during periods of extreme negative returns."[6] The OEA analysis does not support the theory that short sellers caused precipitous declines in a broad number of stocks. This result is consistent with academic research that analyzed global stock markets and concluded that "At the market level, where regulators might expect short sales restrictions to reduce the severity of broad declines, short sales restrictions appear to make no difference."[7]

Not only is short selling generally not responsible for market declines, but a short sale price test is an ineffective tool for preventing such declines. The OEA in its "Analysis of a short sale price test using intraday quote and trade data" based on data from September 2008 found that:

> Counter to the intent of such a rule, we also found that a short sale price test would be most restrictive during periods with little volatility. The rule would be less restrictive on short sale orders during periods of large positive returns and large negative returns, though the restrictions are greater in rapidly declining markets compared to rapidly advancing markets.[8]

The Commission has taken a number of actions focused on manipulative or abusive short sales, including "naked" short sales. Fails to deliver, a primary indication of naked short selling, were dramatically reduced after Rules 204T and 10b-21 were adopted. The Commission recently made Rule 204T final and provided for additional transparency of short sale data. Making this data widely available will provide academics and investors with a valuable tool to find potentially manipulative activity and to study the ongoing impact of short selling on market quality. We believe these actions were much more effective in combating manipulative short selling than a potential broad price test, without the accompanying reduction in market quality.

IV. Circuit Breaker

While we urge the Commission not to adopt any price test, if the Commission were to adopt a price test, Hudson River Trading believes it should be done only in connection with a circuit breaker. A circuit breaker approach would better balance the positive market quality associated with legitimate short selling with the potential harm associated with manipulative short selling. A circuit breaker would better target situations that could result from false rumors, potential bear raids and other forms of manipulation that may be used to drive down or accelerate the decline in the price of a stock. It is unclear whether or not the so-called magnet effect would impact stocks trading near the circuit breaker.[9] However, even if the magnet effect were to prove true, we believe the potential harm to investors associated with it would be far less than the harm to investors of degrading market quality by reinstating a price test at all times. Furthermore, we are unconvinced by arguments that stocks that hit

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[6] Id.

[7] Bris, Arturo, Goetzmann, William, and Zhu, Ning, *Efficiency and the Bear: Short Sales and Markets around the World* (Jan. 2003).

[8] Office of Economic Analysis, *Analysis of a short sale price test using intraday quote and trade data* (Dec. 17, 2008) available at http://www.sec.gov/comments/s7-08-09/s70809-368.pdf.

9 The so-called "magnet" effect asserts that when a rule-based impediment to trade is implemented, investors trade in advance of the specified limit. This behavior pushes prices further towards the limit, increasing the likelihood that the limit is reached.

the circuit breaker will be stigmatized. It is unclear why implementing a price test for the remainder of the day when a stock falls by a certain amount would stigmatize a stock any more than a stock that experiences a large intraday decline today.

Hudson River Trading believes that any circuit breaker should be calculated based on the opening price of the security. Using the opening price to determine the circuit breaker takes into account that material news, such as earnings, is released either after the close or before the open. In the event of a halt, the re-opening price of the security should be used to determine the circuit breaker as stocks are often halted to accommodate the intraday release of material information. This approach ensures that short selling is not restricted based on material public information being factored into the price of the stock.

V. Alternative Uptick Rule

The proposed Alternative Uptick Rule is the most restrictive of the price test proposals insofar as it would not allow, in any circumstance, a short sale order to immediately execute against a passive bid. As such, we expect that the Alternative Uptick Rule would result in the largest degradation of market quality of the price test proposals. We believe the more restrictive Alternative Uptick Rule would be particularly bad for price discovery as it would reduce the information reflected in quotes more than the other proposals. On the other hand, the Alternative Uptick Rule would be easier to implement relative to the Uptick Rule and the Modified Uptick Rule, which require sequencing of trades and bids respectively.

If the Commission adopts Alternative Uptick Rule, Hudson River Trading believes it should be done only in conjunction with a circuit breaker. Given that the circuit breaker provides a more focused approach to restricting short sales, we believe that a relatively more restrictive price test is not inappropriate when the circuit breaker is triggered. We believe that, in conjunction with a circuit breaker, the Alternative Uptick Rule is preferable to the Uptick Rule and the Modified Uptick Rule as its cost and burden of implementation for firms will be lower.

VI. Exceptions

The Commission included a number of potential exceptions to the short sale price test and requested comment on a market maker exception. Hudson River Trading recognizes that many activities involving short selling, including arbitrage and market marking, are advantageous to market quality and price discovery. However, these activities are not unique in contributing to market efficiency; all market participants, regardless of trading frequency or professional expertise, improve market quality by their very participation, whether or not their trading activity is arbitrage or professional market making. We believe that the Commission's goal should be to implement rules that are sufficiently focused and require few, if any, exceptions to maintain market quality.

Exceptions from any short sale price test would be appropriate only if the application of a price test would have an adverse effect on market quality. But while providing exceptions from a price test might limit the negative effect of a short sale rule in the aggregate, it would also serve to privilege certain types of trading and business models over others thereby degrading competition among market participants. Hudson River Trading believes that the most effective regulation would provide a level playing field for all participants, whether industry professionals, institutional investors, or retail investors, and therefore opposes exceptions that would serve to advantage certain participants over others. Furthermore, to the extent the Commission grants any exceptions, additional clarity as to which types of market participants and trading activity would qualify for any such exceptions would help ensure their uniform application.

VII. Conclusion

Hudson River Trading opposes the reinstatement of any short sale price tests as they degrade market quality for investors and are ineffective in combating abusive short selling. If the Commission believes that a price test is necessary, we believe it should adopt the Alternative Uptick Rule in conjunction with a circuit breaker. We believe that any price test should be sufficiently focused, so as to not require extensive exceptions to make the rule workable.

Hudson River Trading appreciates the opportunity to submit these comments. Please do not hesitate to contact us if you have any questions regarding any of the comments provided in this letter.

Sincerely,

Suhas Daftuar
Managing Director