



UBS Securities LLC
677 Washington Boulevard
Stamford, CT 06901
Tel. 203 719-3000

February 14, 2006

The Honorable Christopher Cox, Chairman
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Annette L. Nazareth, Commissioner
United States Securities and Exchange Commission
100 F Street, NE
Washington D.C. 20549-0609

Re: Securities and Exchange Commission Release No. 34-54891; File No. S7-21-06

Dear Chairman and Commissioners:

UBS Securities LLC, the U.S. investment banking arm of UBS AG (“UBS”),¹ respectfully submits this letter in response to the above release.² UBS fully supports the Commission’s proposed rule removing the price test restrictions on the execution of short sales, prohibiting any self regulatory organization from imposing such a price test, and eliminating the requirement that broker-dealers mark an order short exempt to rely on an exception from the price test.³

INTRODUCTION

In 2004, the Commission adopted Section 202T of Regulation SHO, which established procedures for the Commission to temporarily suspend price tests for short sales so that it could study the effectiveness of those tests.⁴ Pursuant to the process established in Rule 202T, the Commission issued an order creating a one year pilot program temporarily suspending the tick test for certain securities. (“Pilot Program”)⁵ After the Pilot Program was complete, the

¹ UBS AG is one of the largest financial institutions in the world serving a diverse client base ranging from affluent individuals to multinational institutions and corporations. The firm has 87 stock exchange memberships in 31 countries, and is widely acknowledged as a leader in the secondary equity trading markets. In the U.S., the firm is active in all of the equity, fixed income and option markets. It is ranked number 1 in equity trading on the NYSE and NASDAQ markets. UBS Investment Bank is a business group of UBS AG. UBS Securities LLC is a subsidiary of UBS AG.

² Securities and Exchange Commission Release No. 34-54891 (December 6, 2006); 71 FR 75068 (December 13, 2006).

³ This letter does not address the issues raised in Securities Exchange Act Release No. 34-54888 (December 6, 2006); 71 FR 75002 (December 13, 2006), dealing with Short Selling in Connection with a Public Offering. It is our understanding that SIFMA is submitting a comment letter on this proposal on behalf of the securities industry.

⁴ Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004).

⁵ Exchange Act Release No. 50104 (July 28, 2004), 69 FR 48032 (August 6, 2004).

Commission's Office of Economic Analysis ("OEA") gathered and examined the market and trading data made available during the Pilot. In September 2006, the OEA issued a draft summary report examining various aspects of market quality including the overall effect of price tests on short selling, liquidity, volatility and price efficiency.⁶ In addition, a number of other reports were issued analyzing the Pilot Program market and trading data.⁷ And, the SEC held a public Regulation SHO Roundtable that focused on the empirical evidence learned from the Pilot data. Based in large part on these reports and the results of the Roundtable, the Commission issued the above cited Release seeking the elimination of price tests for short sales.

DISCUSSION

UBS strongly supports the Commission's proposal to eliminate the price test for short sales and to prohibit SRO's from adopting a price test going forward. The various price tests are inconsistently applied across markets, have little beneficial effect on those markets and cause substantial market inefficiencies and costs in the execution of short sales. We also support the Commission's proposal eliminating the requirement that broker-dealers mark an order short exempt to rely on an exception from the price test since this would no longer be necessary. As noted below, however, the requirement to mark order tickets short exempt may have continuing validity in connection with affirmative determination requirements even if the price test is eliminated. We have cooperated with SIFMA and the STA in drafting their comment letters supporting this proposal and are in full agreement with the points made in those letters. Because of the importance of this issue to the future of the equity trading markets, we file this additional letter emphasizing the key arguments in support of this proposal.

1. The Short Sale Price Test is No Longer Necessary.

As established by the OEA Staff Draft Summary Pilot Report, and as confirmed by the Regulation SHO Roundtable held by the Commission and the independent academic studies of the effect of the Pilot Program on the markets, the price test is no longer necessary. The price test was first adopted as a prophylactic rule in 1938 to protect the markets against bear raids and other manipulative short selling schemes and has remained substantially unchanged since that time. Since the adoption of the rule, the trading markets have changed dramatically. Most significantly, the markets have become much more liquid and transparent, much more automated, and are subject to greater regulatory scrutiny. And, as the studies of the Pilot Program clearly demonstrate, there is little empirical justification for retaining the price test restrictions, especially for actively traded securities. Most significantly, the Pilot Program data did not indicate any association between manipulative short selling, such as "bear" raids, and the price test restrictions. There was no indication that removal of the price restrictions would have a negative impact on the market for those securities.

⁶ Office of Economic Analysis, Securities and Exchange Commission, Economic Analysis of the Short Sale Price Restrictions under the Regulation SHO Pilot (September 14, 2006) ("OEA Staff Draft Summary Pilot Report").

⁷ See, Karl Diether, Kuan Hui Lee and Ingrid M. Werner, Its SHO Time! Short-Sale Price-Tests and Market Quality, June 20, 2006; Gordon J. Alexander and Mark A. Peterson, (How) Do Price Tests Affect Short Selling?, May 23, 2006; J. Julie Wu, Uptick Rule, Short Selling and Price Efficiency, August 14, 2006 ("Wu").

The price test has outlived its usefulness. As noted above, the price test is not necessary to prevent fraud and manipulation. The general anti-fraud and anti-manipulation provisions still apply to these types of transactions. The increased transparency of the markets and enhanced surveillance techniques make detection and prosecution of manipulative activities easier and more effective. And, the enhanced affirmative determination requirements under Regulation SHO are effective in preventing naked short selling and the abuses that occur because of that practice.

2. The Price Test Causes Substantial Inefficiencies in the Execution of Short Sales.

On the other hand, the price test causes substantial inefficiencies and costs in executing short sales. This is particularly true in the area of program trading and other strategies where executions of short sales as part of a larger overall program are often disrupted. Similarly, orders for VWAP and other benchmark transactions and for stops entered during the trading day cannot be executed in compliance with the tick test if the market has risen throughout the day. In the past, many short sale orders were executed after the close of the consolidated tape or in the foreign markets to avoid the impact of the short sale rules. More recently these trades have been executed on markets that do not have a price test. The price test thus adds unnecessary costs and inefficiencies to the routing and execution of legitimate transactions. In addition, there are substantial programming, implementation, and ongoing compliance costs associated with maintaining the rules. These costs greatly outweigh any continuing benefit of the rule.

3. The Various Price Tests Cause Inconsistent Regulation across Markets and Securities.

The short sale price tests differ across the markets, with a tick test for listed securities, a bid test in certain markets for OTC securities, and no regulation in other markets. This leads to regulatory arbitrage which results in distorted routing determinations and in inefficient execution of transactions. More significantly, the Commission has granted numerous exceptions and no-action letters to the price test for various types of transactions. Thus, the price tests do not apply uniformly to all short sales. And, currently, the rules only apply to the more liquid markets, while the pink sheet and bulletin board markets, where the most illiquid securities with the highest potential for manipulative activities trade, do not have similar restrictions. These inconsistencies in the regulatory scheme undercut the rationale for a price test and mandate a change to the current structure. We agree with the Commission proposal that the right approach is to eliminate the pricing requirements entirely.⁸ It is also necessary to prohibit the individual markets from adopting some form of these tests in the future.

4. Regulation NMS Accelerates the Need to Eliminate the Short Sale Price Tests.

The nature of equity trading will change substantially under SEC Regulation NMS. Rather than execute in one or a few markets, trading centers and broker dealer firms will be obligated to protect displayed quotations in all automated trading markets. In many cases, the order will have to be executed in numerous markets to be in compliance with the new regulations. As has been

⁸ It is our understanding that if the Commission were to decide to impose a modified price test, that it would do so by proposing a new rule subject to comment by the public. In any event, if the Commission were to decide that some form of price test is necessary, we would urge that the restrictions be consistent across all markets.

noted in ongoing discussions of SIFMA with the Commission regarding implementation of Regulation NMS, there are numerous inconsistencies in the interaction of the new trade through requirements with the short sale rules. This is further exacerbated by the differences in the application of the price tests in the different securities markets. It is possible that under Regulation NMS, one short sale order could be subject to three or more different price tests in different markets. While there have been ongoing discussions between the SEC and the securities industry to resolve these issues, the elimination of price tests across all markets is the best and most desirable resolution of this issue.

It is critical that the Commission keep the NMS implementation schedule in mind when deciding whether to eliminate the short sale price test. Trading Centers and broker dealers should not be required to program all of their trading systems to be in compliance with the short sale price test in connection with rollout of Regulation NMS, and then shortly thereafter be required to re-program all of those trading systems if the Commission should decide to eliminate or modify the price test. The unnecessary cost of this programming across the industry would be large as noted by SIFMA in its ongoing discussions with the Commission on this issue and in its comment letter on this proposal. We urge the Commission to expedite the decision on the price test so that firms have sufficient time to program changes into their systems prior to the broker dealer implementation date in July 2007. If final resolution of this issue is not possible by that date, we urge the Commission to grant temporary exemptive relief from making those changes until the final decision is made.

5. Proposed Elimination of “Short Exempt” Marking Not Required.

The short exempt marking requirement serves a dual purpose under the current price tests and the affirmative determination requirements under Regulation SHO. If the Commission eliminates the price test, there would no longer be any reason to mark tickets short exempt for pricing purposes. However, there would be a continuing need to identify certain short sale transactions as exempt from the affirmative determination requirements for regulatory and compliance requirements. Thus, the Commission should retain the short exempt marking requirement for those purposes but clarify that it only applies to the affirmative determination requirements.

CONCLUSION

UBS strongly urges the Commission to adopt the proposed rule eliminating the price restrictions on the execution prices of short sales and prohibiting any self regulatory organization from imposing such a price test. And, we support eliminating the requirement that broker-dealers mark an order short exempt to rely on an exception from the price test, while retaining the short exempt identifier for compliance with other short sale requirements. We also request that the Commission act quickly to coordinate the elimination of the price test with the implementation of Regulation NMS to avoid the inconsistent and costly programming that would be necessary if the deadlines were not coordinated. Thank you for your consideration of this letter. If you have any questions or would like any further information regarding the issues raised in this letter, please call the undersigned at (203) 719-1511.

Sincerely,

S/Gerard S.Citera

Gerard S. Citera
Executive Director
U.S. Equities
UBS Securities LLC

CC:

Eric Sirri, Director, SEC Division of Market Regulation

Robert Colby, Deputy Director, SEC Division of Market Regulation

James A. Brigagliano, Associate Director, SEC Division of Market Regulation

Josephine J. Tao, Branch Chief, Office of Trading Practices and Processing, SEC Division of
Market Regulation

Lillian Hagen, Special Counsel, Office of Trading Practices and Processing, SEC Division of
Market Regulation

Victoria L. Crane, Special Counsel, Office of Trading Practices and Processing, SEC Division of
Market Regulation