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January 12, 2009

Via Electronic Mail (rule-comments@sec.gov)

Ms. Florence E. Harmon  
Acting Secretary  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549

**RE: Amendments to Regulation SHO (Interim Final Temporary Rule)  
SEC Release No 34-58773, File No. S7-30-08**

**SUBJECT: Robust Regulation and Market Quality: The Importance of Due  
Process in the Course of Self Regulatory Rulemaking**

Dear Ms. Harmon:

Securities and Exchange Commission (SEC) Chairman Christopher Cox's comments in a recent *Washington Post* interview provide us with an opportunity to reflect on some of the events of 2008.

The Chairman stated: "What we have done in this current turmoil is stay calm, which has been our greatest contribution -- not being impulsive, not changing the rules willy-nilly, but going through a very professional and orderly process that takes into account unintended consequences and gives ample notice to market participants," Cox said. This caution, he added, 'has really been a signal achievement for the SEC.'<sup>1</sup> The STA agrees that such an approach to rulemaking, along with strict enforcement of existing regulations, would have been the most prudent course of action during the very turbulent market conditions in 2008.

<sup>1</sup> Amit R. Paley and David S. Hilzenrath, "SEC Chief Defends His Restraint," *The Washington Post*, December 24, 2008.

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*Dictum Meum Pactum*

The Security Traders Association (STA) has long enjoyed a good working relationship with the Commission on matters relating to market structure and looks forward to deepening our relationship with the Commission in the future. Our experience in working with the Commission has always been positive, as Commissioners and staff alike have engaged in a professional, meaningful, and informed dialogue with the STA on numerous market structure issues over the years.

The STA has long supported appropriate regulation and unbiased enforcement of regulations. We are, and have long been, proponents of a rulemaking environment where interested parties have the opportunity to air their opinions on issues, opinions that are then fully considered by regulators before final rules and regulations are promulgated. Rules and regulations are best vetted with the input of a diverse group of practitioners who openly express their viewpoints. This debate affords many different perspectives to be heard and often identifies potential unintended consequences of proposed regulation. Our financial markets cannot function efficiently when rules and regulations are changed in the heat of the moment. In our current environment of exceedingly interconnected markets even seemingly very minor changes can have disastrous unintended consequences.

The *Washington Post* interview went on to say that Chairman Cox said, "...the biggest mistake of his tenure was agreeing in September to an extraordinary three-week ban on short selling of financial company stocks. But in publicly acknowledging for the first time that this ban was not productive, Cox said that he had been under intense pressure from Treasury Secretary Henry M. Paulson Jr. and Fed Chairman Ben S. Bernanke to take this action and did so reluctantly."<sup>2</sup>

The SEC Commissioners are required by statute to be appointed from both sides of the political aisle, which is a deliberate attempt to minimize political influence. The STA believes that our markets also need to be shielded from political pressures and ad hoc actions that threaten to exacerbate, rather than ameliorate, market problems. It matters little whether it was Treasury Secretary Henry Paulson, Federal Reserve Chairman Ben Bernanke or the leaders of our nation's investment banks, who placed the SEC under intense political pressure to enact the emergency order banning short sales in financial issues. While we recognize – and as traders, appreciate the seriousness of – the extreme market turmoil experienced during the SEC's short sale rulemaking, the fact is that the SEC succumbed to that pressure and changed the rules on short selling without due process, in an impulsive manner, and with an extremely accelerated compliance deadline.

The need for an orderly rulemaking process, with ample opportunity for input by the public and interested parties is codified in the Administrative Procedures Act (5 USC 553) (APA). Enacted in 1946, the APA provides the foundation for the agency rulemaking process. The APA itself embraces the principles of the Fifth Amendment right to due process. The STA believes that our forefathers had great insight when they enumerated this principle in the Bill of Rights.

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<sup>2</sup> Amit R. Paley and David S. Hilzenrath, "SEC Chief Defends His Restraint," *The Washington Post*, December 24, 2008.

The APA governs agency rulemaking and lays out the required rulemaking process. Among the requirements included in the APA is one where independent agencies solicit comments from affected parties. This required comment period permits the collection of informed opinions regarding how the proposed regulation might work and also serves as a cooling off period, allowing for deliberative review and limiting political influence. The notice and comment process improves regulations by testing them “by exposure to diverse public comment,”<sup>3</sup> and by providing “fairness to affected parties.”<sup>4</sup>

While limited exceptions to this process are allowed for in the APA, the use of those, and other similar exceptions, should be exercised only in exceptional circumstances. The SEC used its emergency authority under Section 12k of the Securities and Exchange Act of 1934<sup>5</sup> (one such similar exception to Due Process rules) twice in 2008 to circumvent the notice and comment process. The SEC did not use this authority in this manner from its inception in 1934 until the opening of markets after the September 11, 2001 terrorist attacks.<sup>6</sup> When the SEC used this emergency authority in September 2001, it did so to provide temporary regulatory relief to facilitate the reopening of the markets, including allowing public companies to repurchase their own securities without needing to comply with volume and timing restrictions.

#### *The SEC's Extraordinary Response*

In contrast, the SEC used the authority this year to impose new restrictions on trading by implementing a temporary ban on short selling, resulting in greater volatility, loss of liquidity and increased trading costs (increased costs to borrow securities and increased trading spreads due to greater investor uncertainty). Though the markets went up for a few days because of this government-sponsored short squeeze, that rise was short lived and the markets were down nearly another 20% by the time this government intervention ended. The emergency order also undermined the investor confidence that it was designed to strengthen, as investors became confused about which issues were subject to the order and what the rules would be in the future.

Rushed rulemaking and accelerated compliance requirements increase the likelihood of unintended consequences. It is important to note that the equity markets were literally the last functioning frontier of liquidity during the financial crisis. It was the only market that was not frozen by fear, but the emergency order put that liquidity in jeopardy. To comply with the SEC's orders, many firms were forced to have overseas programmers rapidly implement code changes with little or no testing. One minor coding error could have had catastrophic ramifications for the technological backbone that connects our various trading venues. Even without the dangerous code changes, the bandwidth of the marketplace was stretched thin because of the unprecedented volumes generated by the short squeeze. Evidence of the unintended results of the unrealistic implementation deadline was the market opening on September 19, 2008, where thousands of erroneous trades in hundreds of different issues occurred due to the confusion and subsequent loss of liquidity resulting from the lack of clarity on the emergency rule.

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<sup>3</sup> *BASF Wyandotte Corp.*, 598 F.2<sup>nd</sup> at 641.

<sup>4</sup> *National Association of Home Health Agencies v. Schweiker*, 690 F.2<sup>nd</sup> at 949.

<sup>5</sup> Section 12k permits the SEC, to take an emergency action “to alter, supplement, suspend, or impose requirements or restrictions with respect to any matter or action” under the purview of the SEC, if the Commission determines such action is “necessary in the public interest and for the protection of investors” for maintaining “fair and orderly” markets.

<sup>6</sup> House of Representatives Report 108-19, Emergency Securities Response Act of 2003 p. 2.

A review of trading patterns after the emergency order indicates that it had little impact on the prices of financial stocks. Financial stocks that were subject to the short selling ban lost 17.7% during the ban versus a loss of 18.4% for the S&P 500. This was hardly a noticeable difference. What was clearly noticeable to market professionals during the ban was: (1) lower volumes in the issues subject to the ban; (2) difficulty in creating and redeeming exchange trade funds; (3) difficulty in arbitrating index positions; (4) reduced liquidity and difficulty in hedging convertible preferred issues (as a matter of fact the convertible market lost virtually all liquidity because of the ban); and (5) difficulty in hedging options positions.

The STA has repeatedly reminded the SEC that:

...we believe that regulatory intervention in the markets should not be done in such a way as to inhibit competitive market forces and practices, which otherwise would have determined prices....We believe that the effects of such regulatory actions are transitory and unsustainable. The markets will find the equilibrium price, which will match supply and demand.

It is our view that the most effective remedy to the current situation is rigorous enforcement of existing laws, rules, and regulations. The current regulatory regime, properly enforced, is sufficient. We believe that additional regulation is neither necessary nor would it be helpful. In particular, the STA has long supported the strong enforcement of the locate and delivery rule designed to prevent abusive or illegal short selling. The STA has previously questioned the appropriateness of certain interpretations of the locate rules and would respectfully suggest that these interpretations are a probable cause for the same piece of stock being used for multiple locates. Further, we support the strong enforcement of regulations and laws aimed at those who engage in market manipulation through the dissemination of rumors, collusive schemes, or other conduct intended to manipulate securities prices.<sup>7</sup>

Observations that short selling abuses could and should be addressed by concentrating on the enforcement of rules on the clearing side of the business have clearly been validated. After the SEC strengthened the clearing rules via the T+3 penalty, the NASDAQ "threshold list" went from 443 names prior to the order, to 95 names in late October, to a list of less than 20 names currently. Overall short selling has been declining since July, before the first emergency order, and this trend will likely continue as hedge funds and other alternative investment providers rebalance their portfolios due to fund redemptions and deleveraging.

#### *Quietly Issued Changes in Interpretative Guidance*

Implementation of the emergency order banning short sales was not the sole instance of the SEC putting politics above investor protection in 2008. A little noticed change in interpretative guidance for proposed SRO rule changes by the SEC was discussed in a June 27, 2008 *Traders Magazine* article, "SEC gives Exchanges Room to Be Their own Bosses." The article reported that:

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<sup>7</sup> STA Comment Letter July 23, 2008, p. 2 and Security Traders Association, *Special Report: The STA's Perspective on U.S. Market Structure*, May 2008 pp. 18 & 19.

“The Securities and Exchange Commission, bowing to pressure from exchanges that say they face greater competition than ever, is proposing to give exchanges more leeway to make quick changes in their markets. The SEC said... it would allow exchanges to institute a broader range of rule changes without getting prior SEC approval. SEC Chairman Christopher Cox observed that “competitive decision making in the marketplace [by exchanges] is now urgent and immediate.” Nasdaq OMX and NYSE Euronext have been outspoken critics of delays associated with the SEC’s rule filing process....To give exchanges more headroom to compete swiftly and innovate, Cox said the SEC would soon issue interpretative guidance expanding the types of rule changes that could be submitted for immediate effectiveness.”<sup>8</sup>

The STA questions how a policy change of this magnitude, which was the subject of the full rulemaking process in 2001 (and was widely condemned at that time), was relegated to an issuance of a final rule and interpretative guidance. Why was there no open meeting of the Commission to discuss such a major change, no recent proposed rule filed and no comment period?<sup>9</sup>

As we discussed in the May 2008 STA Special Report, for-profit exchanges are subject to fewer internal checks and balances than when they were member-owned.<sup>10</sup> Under the new for-profit structure, exchanges have a fiduciary obligation to their shareholders and they must grow their revenues and profits to attract investors. Previously, the membership owned exchanges controlled exchange fees (such as transaction fees, market data fees and post-trade fees) and other rule changes through a system of committees where the exchange fees and rules were deliberated by the exchange membership. Since these same members had to also abide by the new rules or pay the exchange fees, they had a vested interest in keeping fees low and regulation appropriate. This internal control mechanism is no longer in place in the for-profit model, potentially allowing exchanges to promulgate rules that could provide them with competitive advantages.

SEC Chairman Cox recognized this potential for abuse of power in a letter to Congressman Paul Kanjorski dated January 18, 2008, saying:

You also note that many exchanges have demutualized in recent years and become competitive, profit-seeking entities. I strongly agree that the changed relationship between for-profit exchanges and the broker-dealers that formerly owned them requires new thinking about how best to ensure that exchanges continue to meet the needs of investors.

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<sup>8</sup>June 27, 2008 *Traders Magazine* article, “SEC gives Exchanges Room to Be Their own Bosses.”

<sup>9</sup>In 2001, the Commission proposed changes to the SRO rule filing process: Securities Exchange Act Release No. 43860 (January 19, 2001), 66 FR 8912 (February 5, 2001) (S7-03-01).

<sup>10</sup>*Special Report: The STA’s Perspective on U.S. Market Structure*, May 2008 p. 11.

*SRO Rulemaking Moving Forward: Towards an Equitable Solution*

The STA does not believe that allowing SROs more leeway in the rulemaking process is the new thinking that would ensure that exchanges continue to meet the needs of investors. While we believe that the SROs do need proposed rule changes to be approved in a more timely fashion, we do not believe that allowing more rule filings to be immediately effective is the appropriate solution. With the speed and interconnectedness of the market, rule changes at one venue can affect executions on other venues. The STA believes that thorough vetting of SRO rule filings and due process are more important than ever. Allowing time for reasoned informed debate helps to clarify ambiguities in proposed rules, helps to identify unintended consequences and promotes transparency in the markets and the rulemaking process.

The STA supports the notion of user fees to support sufficient funding for the Commission to attract and retain qualified and experienced employees through competitive compensation. The STA supported the Investor and Capital Markets Fee Relief Act (P.L. 107-123) – which among other things, allowed semi-annual adjustments to the Section 31 transaction fee – to ensure that the Commission would have sufficient funding and to provide SEC employees with compensation equivalent to Federal banking regulators. Current market conditions have created an environment where it will be much easier for the SEC to encourage migration of skilled market participants from Wall Street to Washington and the STA respectfully suggests that a more appropriate solution to the problem of delays in the rule approval process would be to hire more experienced and highly trained staff who understand the intricacies of our markets. The SEC could also expedite implementation of the 19 recommendations that its Office of the Inspector General offered in its March 31, 2008 report on the SRO Rulemaking Process.<sup>11</sup> Both or either solution is better than capitulating and allowing the SROs free rein in choosing which rule changes are controversial and which are not.

If the SEC should decide to stay the course on this interpretive guidance, it should make the guidance available to interested parties outside of the SRO community. The guidance should clearly delineate what rules are eligible for accelerated approval and the recourse of interested parties if they object to these rules.

The STA believes that one category of rules that should be eligible for immediate approval would be rules relating to truly new products offered by the exchanges, so long as the new product was not developed using data or information gleaned from their status as an SRO monopoly. New products would have few, if any, legacy users who would be affected by the rule changes. Allowing new products to receive immediate approval could energize the innovative juices at the exchanges and allow them to pursue competitive advantages.

The STA also believes that fee changes should be specifically ineligible for immediate approval. Exchange fees have increasingly been used by exchanges to gain competitive advantage usually by rewarding some market participants to the detriment of others. As pointed out in the 2008 STA Special Report,<sup>12</sup> exchange fees (and specifically market data fees) have become a major source of funds from which trading venues incent some market participants to send their order flow to that venue. The amounts

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<sup>11</sup> SEC Office of Inspector General report on the SRO Rule Filing Process, Audit 438, March 31, 2008, (<http://www.sec-oig.gov/Reports/AuditsInspections/2008/438final.pdf>).

<sup>12</sup> *Special Report: The STA's Perspective on U.S. Market Structure*, May 2008 p. 17.

of fees involved are large enough that businesses have been created whose only goal is to capture market data rebates. Fee issues have become powerful tools of competition and are responsible for changes to our market structure that do not necessarily improve market quality.

### *Unheard Comments*

In 2008, even when the due process rules were followed, the political muscle of the few was recognized above concerns for the many and investor protection. The SEC's hotly debated market data proposal was among the most commented upon issues of the year. Most of the exchanges rallied in support of each other and a host of other commenters weighed in with views on the other side of the issue. The STA commented and discussed the issue in the May 2008 Special Report supporting a holistic approach to the issue over the SEC's proposal to deal with only one aspect of the market data dilemma.<sup>13</sup> The STA does not believe that it is in anyone's interest to employ a hollow comment process. The SEC should study the comments that are presented on every proposed rule change and weigh and respond to those comments in a serious and unbiased way.

Many commenters on the market data issue are perplexed by the Commission's apparent failure to seriously consider all of the comments submitted. Perhaps the Commission's reluctance to consider the contra side of the market data issue stems from the lengthy and complex disapproval process. The SEC's Inspector General's report on the SRO Rule Filing Process describes in detail the arduous process of disapproval and states that the SEC "rarely disapproves a proposed rule change," pointing out that it had not disapproved any proposed rule changes in either 2006 or 2007.<sup>14</sup> The STA hopes that the reluctance of the Commission to consider all of the comments brought forth on the market data proposal is due to the SEC taking the path of least resistance and not because of "regulatory capture."

### *Conclusion*

When Congress approved the self regulatory model for the financial services community the reasoning was two fold: (1) lawmakers believed that industry professionals were far more informed on what rules were needed and how those rules would affect the industry; and (2) the system of self regulation would cost less than direct government regulation. Enlisting the investment community in the design and implementation of regulations for which the government had little expertise has had two effects. First it has allowed the regulators to reap the benefit from the real world experiences of industry professionals, and second the democratization of regulation has encouraged more compliance than a regulatory edict would have.

The vast majority of professionals in the financial services arena are very serious about abiding by the rules and regulations. The Security Traders Association has always promoted the highest professional standards and has also always promoted rules and regulations that would contribute to investor confidence. Our comment letter development process allows proposed comments to be exposed to and debated by a wide swath of industry professionals. The STA develops its comments to proposed rule

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<sup>13</sup> *Special Report: The STA's Perspective on U.S. Market Structure*, May 2008 p. 17.

<sup>14</sup> SEC Office of Inspector General report on the SRO Rule Filing Process, Audit 438, March 31, 2008 p. 7 (<http://www.sec-oig.gov/Reports/AuditsInspections/2008/438final.pdf>).

changes primarily through its system of committees. Comments are proposed by one committee, say our Trading Issues Committee, discussed and debated by that committee and then forwarded to our other committees (the STA Institutional Committee, the STA Options Subcommittee and the STA Order Routing Subcommittee) for discussion and debate. Once the comment has been defined and developed it is approved by the STA Executive Committee and forwarded to the regulator in question. The STA comment letter does not represent a single person's or institution's point of view or any particular business model, but the consensus of many different professionals from many different disciplines within the industry. In forming our opinions in this manner the STA harnesses thousands of years of practical experience to form a comment that the STA believes will promote the greater good for the industry and the investor.

In 2009, it will be extremely important for industry participants, regulators and our political leaders to do everything possible to restore investor confidence. Many rules and regulations will be reviewed. We are hopeful that the SEC's signal achievement during the course of these debates will be its commitment to due process and transparency. As always, the Security Traders Association stands ready to share the collective experience and thoughts of our members on future industry changes. We trust that regulators will seriously consider those comments.

Respectfully submitted,



Peter J. Driscoll  
Chairman



John C. Giesea  
President & CEO

cc: Hon. Christopher Cox, Chairman  
Hon. Luis A. Aguilar  
Hon. Kathleen L. Casey  
Hon. Troy A. Paredes  
Hon. Elisse B. Walter  
Dr. Eric Sirri, Director of Trading and Markets  
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