



June 21, 2004

**VIA ELECTRONIC TRANSMISSION;
CONFIRMATION BY OVERNIGHT MAIL**

Mr. Jonathan G. Katz
Secretary, Office of the Secretary
Mail Stop 0609
Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549

**Re: Arca Ex Comments In Response to Proposed Regulation SHO
Release No. 34-48709, File No. S7-23-03**

Dear Mr. Katz:

On behalf of Archipelago Holdings, L.L.C. and its wholly owned subsidiary ArcaEx (collectively "Archipelago")¹, this letter respectfully sets forth our comments in response to the Securities and Exchange Commission's ("Commission" or "SEC") proposing release regarding Regulation SHO.² As a marketplace for the trading of exchange-listed ("Listed") and over-the-counter ("OTC") securities, Archipelago has an interest in the sound functioning of short sales in its market.

Archipelago is generally supportive of the Commission's proposed Regulation SHO and, in particular, the proposed pilot to eliminate the proposed bid test for specified liquid securities for a two-year pilot ("Short Sale Pilot"). We agree that the Short Sale Pilot will be an effective

¹ In October 2001, ArcaEx was approved by the Securities and Exchange Commission to operate a fully automated exchange trading facility independently regulated by Pacific Exchange, Inc. ArcaEx is available to execute trades in over 8,000 exchange-listed and OTC securities and as of March 31, 2004 handled over 25% of total trading volume in OTC securities, over 17% of total trading volume in Amex-listed securities and approximately 1.6% of total trading volume in NYSE-listed securities. As of March 31, 2004, our ETF volume represented over 3.0 billion shares.

² Securities Exchange Act Release No. 48709 (October 29, 2003) ("Proposing Release").



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mechanism for the Commission to study the effects of unrestricted short selling on market volatility, price efficiency, and liquidity.

Setting the Record Straight

Today, ArcaEx is subject to the price test of the SEC's Rule 10a-1 for Listed securities. In OTC securities, ArcaEx operates without a price test for short sales because we believe that price discovery for stocks is truest when there are no price restrictions on short sales.

Until the late 1990s, the vast majority of OTC trading was executed in the Nasdaq marketplace ("Nasdaq"), which is an equities trading facility of the NASD and regulated by NASDR, and was subject to the NASD's price test for short sales. With the introduction of healthy competition from ArcaEx and other exchanges, substantial trade execution has migrated away from Nasdaq. Nasdaq disingenuously complains in its Regulation SHO comment letter and other forums that competition from exchanges like ArcaEx and the choice to forgo a price test for short sales has led market participants to route orders away from Nasdaq for the purpose of "regulatory arbitrage." Funny that while Nasdaq carps and harangues to the Commission and the industry about regulatory arbitrage in short sale regulation, Nasdaq itself is engaged in one of the great regulatory arbitrages in short sale regulation. The dirty little secret of Nasdaq's "short sale price test" is that Nasdaq exempts its market makers from the rule. So Nasdaq says one thing but does another. Which reasonably leads to the query: does Nasdaq believe that its wholesale carve-out of the NASD price test for substantially all of its trading harm investor protection and lead to poor trade execution at Nasdaq?

When you get beyond the smoke and mirrors and the obfuscation and the hypocrisy, one finds – as is almost always the case with Nasdaq, past and present – that Nasdaq's real worry is competition from other markets. According to the lips of the NASD and Nasdaq, their purpose in permanently adopting the NASD price test (from which they then exempted most Nasdaq trading) had nothing to do with investor protection or execution quality or doing right by the national market system. Instead, it had to do with Nasdaq's parochial financial interest in competing with the NYSE for issuer listings. In 1997, when the NASD was pushing to maintain the bid test as a permanent rule, the NASD stated that, without it, "Nasdaq could potentially lose issuers to other marketplaces simply because those markets have a [price test] rule in place."³ History shows that the NYSE had been selling against Nasdaq to issuers based on the fact that Nasdaq initially had no short sale rule. So Nasdaq got its cake and ate it too: it "adopted" a short sale rule (so it could effectively market to issuers and eliminate NYSE's comparable selling

³ Securities Exchange Act Release No. 38979 (August 26, 1997).



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advantage) and then exempted most of the trading on Nasdaq from its own short sale rule. Now that's the Oxford Dictionary definition of "regulatory arbitrage!"

Price Test Proposal

We support the Commission's proposed Short Sale Pilot. Should the Commission pursue this pilot program, all marketplaces should be required to participate to allow the Commission to study the results of the pilot across all markets.

While we maintain that no price test is necessary for short sale regulation, should the Commission determine a price test is necessary, Archipelago urges the Commission to adopt the test described as the "Alternative Bid Test." We agree with others who have expressed concern that the proposal "Uniform Price Test" under Regulation SHO will introduce unnecessary inefficiencies into the market. Most notably, the proposed Uniform Price Test under Regulation SHO would require all short sales be executed at one penny above the prevailing national best bid regardless of the direction of the most recent change in the bid price. This aspect of the proposal would inhibit price discovery information with minimal investor protection benefits.

In addition, it is not clear from the Commission's proposal how a short sale order that has been entered but not yet executed should be handled in the event that the bid move to a higher price. If the Commission's proposal is that the sell short order should be forced to reprice, these short sale orders will play no role in price discovery. In contrast, under the Alternative Bid Test, once the consolidated bid is higher than the previous bid, short orders can execute against that bid and full representation of trading interest is achieved.

We agree that the use of consolidated data is superior to individual markets using their own data, and that any short sale rule adopted must uniformly reference consolidated data for trades on all exchanges. While some participants may prefer using transaction data, we believe using consolidated quote information is superior in determining short sale pricing tests as it provides a more meaningful picture of the market place. Quotes show the value and likelihood of potential transaction prices whereas executions provide a historical record.

In addition, we support the use of the Alternative Bid Test in early and late trading during the times that the SIPs publish quotes. During these periods, positioning quotes and quotes from exchanges that are closed should not be used for pricing tests. In the absence of consolidated bid information, when trading occurs beyond the hours of the SIP, each exchange should calculate the Alternative Bid Test based on its own quotes.



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Locate and Delivery Requirements

Broker-dealers effecting short sales for their own account or the accounts of customer must be in a position to complete the transaction and, as such, Archipelago supports the Commission's proposal for a uniform "locate" rule. The exemptions from the locate requirements must apply equally across all market structures, however.

As proposed, Rule 203(b) appears to be overly broad. Proposed Rule 203(b) states that a "broker or dealer may not execute a short sale order for...the account of another person unless the broker or dealer, or the person for whose account the short sale is executed" has met the locate requirements of the proposed rule (emphasis added). Under the Exchange Act of 1934, the definition of "person" includes a company, i.e., a broker-dealer.⁴ This formulation of the locate rule will require every broker-dealer that handles the order to perform the locate test, creating unnecessary duplication of efforts. For example, if a broker-dealer is acting as agent for a customer order and routes that order to a broker-dealer acting as market maker, both the initial broker-dealer and broker-dealer acting as market maker must satisfy the locate requirement. Instead, we propose that only one broker-dealer – the broker-dealer that accepted the order – be responsible for the locate requirement.

We encourage the Commission to revise Rule 203(b) to reflect the standard of the NASD's locate requirement, NASD Rule 3370. In the NASD's formulation of the locate requirement, a member firm is responsible for the locate on any customer orders accepted by the member. Similarly, the member firm is responsible for any locates on proprietary transactions initiated by the member. Should these orders be routed to another member firm, the second firm should not be responsible for satisfying the locate requirements because the locate requirement appropriately rests with the firm originating the order.

Alternatively, should the Commission pursue the locate requirement as proposed, the Commission's proposed exemption from the locate requirement for "market makers" and "specialists" must be modified to include all broker-dealers engaged in facilitating customer orders. The Commission's rationale for providing an exception for bona-fide market making activities is that specialists and market makers "may need to facilitate customer orders in a fast moving market without possible delays associated with complying with the proposed 'locate' rule."⁵ Many broker-dealers, though not "market makers" or "specialists" per se, also facilitate

⁴ "The term 'person' means a natural person, company, government, or political subdivision, agency, or instrumentality of a government." *Section 3(a) of the Securities Exchange Act.*

⁵ The Proposing Release goes on to say that [t]he exemption for bona-fide market making activities would exclude activity that is related to speculative selling strategies or investment decision of the broker-dealer or



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customer orders in fast moving markets and execute customer orders and require the same ability to execute customer orders without the possible delays associated with a locate requirement. Artificially limiting the exception to “market makers” and “specialists” discriminates against and competitively disadvantages broker-dealers who execute trades on order-driven and agency markets such as the ArcaEx in contrast to the specialist/dealer-centric markets of the Nasdaq and NYSE. Traditional notions of equity and fairness dictate that all broker-dealers serving an identical function should be allowed to utilize such an exemption.

The uniform locate requirement coupled with the Commission’s proposal to impose penalties for extended fails to deliver will largely address naked short selling. The problems attributed to short selling are most appropriately regulated by taking away the economic incentives for improper short sales. We agree with 90-day prohibition in selling short the security if a fail occurs for more than six days after settlement. We also agree with the Commission’s proposal that if a short seller fails to deliver, the account should not receive any mark-to-market benefits (profit) until such point as settlement is made. This will quickly correct the economics involved with naked short selling and is probably the most important and effective feature of Rule 203.

associated person is disproportionate to the usual market making patterns or practices of the broker-dealer in that security.” Proposing Release at footnote 49.



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We thank the Commission for the opportunity to comment on this important proposal. We are prepared to discuss our comments with the Commission upon request.

Respectfully submitted,

ARCHIPELAGO HOLDINGS, L.L.C.



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cc: The Honorable William H. Donaldson
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