

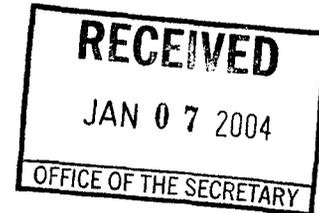


JOHN H. BLUHER  
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January 6, 2004

Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, D.C. 20549-0609



Re: File No. S7-23-03 - Proposed Regulation SHO  
Release No. 34-48709 (Oct. 28, 2003), 68 FR 62972 (Nov. 6, 2003)

Dear Mr. Katz:

Knight Trading Group, Inc. ("Knight") welcomes the opportunity to provide our comments to the Securities and Exchange Commission ("Commission") on proposed Regulation SHO. As a general matter, Knight supports the Commission's effort to replace the disparate short sale requirements that exist under Commission rules and the rules of various self-regulatory organizations ("SROs") with a set of uniform requirements.<sup>1</sup> We are concerned, though, that specific features of the proposal will impose unnecessary restrictions on over-the-counter ("OTC") market makers that will undermine their ability to provide critical liquidity, especially in less liquid stocks listed on the Nasdaq Stock Market ("Nasdaq").

Market makers perform an essential service by providing market liquidity in their registered stocks. Their effectiveness as liquidity providers, though, depends upon having the flexibility to engage in short selling activity when acting in their market maker capacity. Thus, Knight urges the Commission to exempt bona fide market making from the operation of the proposed bid test and delivery requirements based upon the definitions of "market maker" and "bona fide market making activity" along the lines we propose below. This approach, we believe, will provide meaningful constraints on market maker short selling practices because of the inherent standards a market maker must follow to fulfill its trading obligations, most notably the obligation to provide continuous two-sided markets. Providing an exemption for market makers will permit them to adjust their inventory and risk profiles in a way that will permit them to continue to provide liquidity at the times that inevitably occur when market conditions require a significant commitment of capital and concomitant management of risk.

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<sup>1</sup> Commission Rule 10a-1 and related Rules 3b-3 and 10a-2 impose one set of requirements on short selling of exchange-listed securities, wherever they are traded. NASD Rule 3350 imposes a different set of requirements on short selling of Nasdaq NMS stocks but no restrictions apply to Nasdaq SmallCap or bulletin board securities. The NASD's restrictions only apply to trading of Nasdaq NMS securities in the Nasdaq market and not on any exchange. An exchange that trades Nasdaq NMS stocks may but is not required to adopt its own short sale rule covering trading of such stocks in its market.

The Commission's preliminary decision not to exempt market makers from the proposed short sale price test (the uniform bid test) is of particular concern. It represents a significant departure from current practice with respect to Nasdaq NMS securities, in that the National Association of Securities Dealers, Inc. ("NASD") exempts Nasdaq market makers from its short sale price test (as well as other short sale restrictions). If adopted, the restriction will greatly discourage bona fide OTC market making activity in Nasdaq NMS securities. Moreover, the restriction rests upon the faulty assumption that market makers rarely if ever need to sell to the inside bid to fulfill their market making obligations. Other proposed restrictions will also needlessly inhibit prudent market maker behavior, to the detriment of market liquidity, and should be reconsidered.

## **I. Knight's Standing as a Market Maker**

Knight has extensive OTC market making experience in both Nasdaq and exchange-listed stocks through our two subsidiaries, Knight Equity Markets, L.P. ("Knight Equity") and Knight Capital Markets, LLC ("Knight Capital"). Knight is unique in that OTC market making constitutes our *primary* business, which we perform on a wholesale basis providing essential liquidity to other broker-dealers and institutions. Unlike most other market makers, we are not part of an integrated broker-dealer where market making is an adjunct to the brokerage or investment banking business.

Knight Equity is registered with the Nasdaq Stock Market ("Nasdaq") as a Nasdaq market maker in all Nasdaq-listed stocks. It is, by far, the largest market maker in terms of the number of stocks it trades as well as the volume and number of trades it executes. In 2003, Knight Equity traded almost 381 billion shares of Nasdaq stocks. Knight Capital is registered with Nasdaq as a CQS market maker for all exchange-listed stocks trading in the Nasdaq InterMarket. In 2003, it traded almost 59 billion shares in exchange-listed stocks. We have gained a thorough understanding of how the U.S. equity markets operate from these activities, and are frequently called upon to offer our views on issues relating to market structure and market making. We have drawn upon our extensive experience in formulating our comments.

## **II. Comments**

### **A. General**

The Commission has identified several problems with short selling that Regulation SHO is intended to address. First and foremost, the Commission cites the traditional concern that short selling can be used to manipulate stock prices by exhausting displayed bids or trading at successively lower prices to convey a false impression that an issuer is experiencing problems, thereby inducing others to sell the stock, further depressing the stock's price. Second, the Commission raises the related concern that unrestricted short selling could exacerbate a stock's price decline in a down market, apart from any manipulative intent. Finally, the Commission expresses concern that "naked short selling" in which the seller does not borrow the securities needed to meet its delivery obligation can result in a significant number of delivery failures within the clearing system, which may remain open for an extended time.

At the same time, the Commission recognizes that short selling provides two important benefits to the equity markets. First, it allows market makers (and other market participants) to provide liquidity to the markets. Indeed, the very function of a market maker is to provide liquidity by “[holding] himself out ... as being willing to buy and sell [a] security for his own account on a regular or continuous basis.”<sup>2</sup> Market makers could not meet their affirmative trading obligations without the ability to sell short. Second, short sellers are seen to contribute to pricing efficiency because their transactions signal their evaluation of a stock’s future performance to the market, which absorbs and reflects that information in the price of that security.

The Commission’s challenge is to adopt short sale requirements that mitigate the potential for abuse without jeopardizing the recognized benefits of short selling. Regulation SHO does not meet that challenge. As explained in the following sections, Regulation SHO would impose material new restrictions on short selling by OTC market makers that will significantly impair their ability to provide the liquidity that investors have come to expect as a matter of course. Most notably, these include the proposed uniform bid test and delivery requirements, both of which are more restrictive than existing standards imposed on Nasdaq market makers and, unlike the NASD rules they would supercede, contain no exemption for market makers.

We also believe that the short sale problems the Commission has identified, while unquestionably serious, occur on an infrequent basis relative to total market activity. It is our understanding that a small number of issuers and investors have complained about short selling abuses, but that their concerns are largely confined to trading in so-called “micro cap” stocks.<sup>3</sup>

Our comments focus on the OTC markets for Nasdaq stocks, where proposed Regulation SHO will have the most profound impact by eliminating the market maker exemption and further restricting the bid test. Although third market makers have traded without the benefit of a market maker exemption since the 1970’s, due to important differences in how Nasdaq stocks are traded compared to exchange-listed stocks, we do not believe this experience dictates eliminating the exemption for Nasdaq stocks. Nasdaq stocks are traded in a highly electronic environment that relies upon multiple competing OTC market makers as the primary pricing mechanism. However, over the past several years there has been a significant reduction in the number of firms making markets and the number of stocks they cover in large part due to the steady decline in market making profits since 2000.<sup>4</sup> This poses a real threat to rigorous inter-dealer

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<sup>2</sup> Section 3(a)(38) of the Securities Exchange Act of 1934, as amended (“Exchange Act”) (defining the term “market maker”). This concept is also incorporated into various Commission rules (e.g., the Quote Rule, Commission Rule 11Ac1-1) and NASD rules (e.g., NASD Rule 4200(a)(23) defining the term “Nasdaq market maker”).

<sup>3</sup> See Gary Weiss, “Don’t Force the Shorts To Get Dressed,” BusinessWeek (Dec. 8, 2003). This commentary piece also makes the case that the short selling practices drawing the complaints may in fact benefit the market by deflating prices of over-hyped stocks to more accurate market values.

<sup>4</sup> The Securities Industry Association (“SIA”) has compiled statistics on the trading profits realized by NYSE member firms that also trade as OTC dealers in Nasdaq stocks. According to the most recent statistics provided by SIA, such firms realized aggregate trading profits of over \$7.5 billion in 2000, but saw their profits drop to around

competition at least in less liquid stocks below the top tier of Nasdaq 100 stocks. Proposed Regulation SHO will impose significant costs that will further erode market making profits and, in the process, weaken inter-dealer competition as existing firms commit even fewer resources and energy to OTC market making and prospective new market making firms find the costs of entry too substantial.

In contrast to Nasdaq stocks, most trading in exchange-listed stocks occurs on the primary exchange markets; approximately 80% of the share volume in New York Stock Exchange ("NYSE") listings, in fact, is executed on the exchange. While third market makers such as Knight Capital are an important source of additional liquidity, the NYSE still constitutes the primary pricing mechanism for its listed stocks. There is no facility in the third market which is the equivalent of SuperMontage or which imposes similar burdens on third market makers. Thus, third market makers do not have the same price discovery role as their counterparts for Nasdaq stocks, with a correspondingly lesser need to anticipate price changes. That said, we believe that the changes we recommend to Regulation SHO will promote and preserve the competitiveness of third market makers as viable alternative markets to the primary exchanges by providing them with greater latitude to compete more effectively without compromising the Commission's underlying regulatory objectives.<sup>5</sup>

Moreover, we believe it is important for the Commission to have a uniform short selling rule in all public markets where equities trade. This is of particular concern should the Commission approve Nasdaq's application to register as a national securities exchange with its decentralized competing dealer structure intact. With differing short sale rules for listed and non-listed stocks, the exchange application approval would create new burdens on market makers without any corresponding change in market structure.

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\$3.66 billion in 2001, \$1.18 billion in 2002 and \$790 million through third quarter of 2003. See [http://www.sia.com/research/html/quarterly\\_securities\\_results.html](http://www.sia.com/research/html/quarterly_securities_results.html). Nasdaq market maker trading profits have been declining principally as a result of decimalization leading to reduced spreads, combined with reduced trading volume, the impact of the Commission's Limit Order Display Rule, Rule 11Ac1-4, and trading on electronic communication networks ("ECNs").

<sup>5</sup> Under the current tick test in Commission Rule 10a-1, for example, a third market maker can sell short to the bid if the bid is higher than the preceding trade price for the security or is at the last trade price if that price is higher than the last different price. Under the proposed bid test, the market maker could never sell to the bid, but our proposal would allow that. In Section C.1. of this comment letter, we explain the market conditions under which a market maker would want to sell to the bid in a rising market, which the current tick test accommodates.

## **B. Need for a General Market Maker Exemption**

In lieu of imposing new restrictions on market makers, we believe a better approach would be for the Commission to provide market makers flexibility to engage in short selling, but to limit that relief to transactions that constitute bona fide market maker trading activity. Those functions, properly performed, in and of themselves guard against the risk of market makers engaging in abusive short sale practices.

Under Commission and SRO rules, market making generally entails the obligation on the part of a market maker to provide continuous markets in its registered stocks.<sup>6</sup> This means that a market maker is required to enter and maintain a *two-sided quotation* for each stock in which it is registered.<sup>7</sup> The very nature of the quoting obligation mitigates against short sale abuses: it prevents a market maker from quoting on the sell side of the market alone, without providing some counterbalancing trading interest on the buy side (for at least one normal trading unit). Market maker quotes must be firm<sup>8</sup> and must also be competitive and bear a reasonable relationship to the prevailing market,<sup>9</sup> providing further constraints on market maker short selling activity. Finally, a market maker has a strong incentive to perform its market maker functions in accordance with applicable SRO and Commission rules: the risk of losing its market maker registration in a stock if it does not.<sup>10</sup>

We propose that the Commission add definitions for the terms “market maker” and “bona fide market making activity” to Regulation SHO to delineate trading activity eligible for a market maker exemption from various provisions of the regulation. We believe the definitions should contain the following elements:

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<sup>6</sup> See, e.g., Commission Rules 11Ac1-1(a)(13), 11Ac1-2(a)(13), 11Ac1-4(a)(9) and 11Ac1-5(a)(18) (each defining “OTC market maker”); Commission Rule 3b-8(a) and (b) (defining “Qualified OTC Market Maker” and “Qualified Third Market Maker,” respectively, for purposes of Regulation U); Commission Rule 15c3-1(c)(8) (defining “market maker”) and NASD Rules 4200(a)(5), 4200(a)(23) and 4200A(a)(10) (defining “CQS market maker,” “Nasdaq market maker” and “Registered Reporting ADF Market Maker,” respectively).

<sup>7</sup> This is implicit in the rules cited in n. 6, *supra*. The NASD makes this explicit in its Rule 4613(a).

<sup>8</sup> See, e.g., Commission Rule 11Ac1-1(a)(13) and NASD Rule 4613(b). We do not consider ECNs to be market makers.

<sup>9</sup> See, e.g., Commission Rules 3b-8(a) and (b) and Commission Rule 15c3-1(c)(8) (including the concept of providing competitive quotes in their respective market maker definitions), NASD Rule 4613(c) (market maker quotes must be reasonably related to the prevailing market).

<sup>10</sup> SRO rules may impose additional standards defining a market maker’s trading obligations. The NASD, for example, prohibits a market maker from entering quotations that lock or cross the market, except under certain circumstances. NASD Rule 4613(e). Market makers are also required to enter and maintain a two-sided quotation with a minimum spread increment of 1¢. NASD Rule 4613(b). Nasdaq market makers are also subject to periodic evaluation under performance standards relating to the amount of time it maintains quotes at the inside bid or offer; how its spreads compare to the average dealer spread; and how frequently it updates its quotations without a corresponding trade occurring within 3 minutes before or after the update. NASD Rule 4612(a).

1. **Market Maker.** We recommend defining this term to cover any dealer that (i) is registered as a market maker in good standing under the rules of an SRO, (ii) holds itself out as willing to buy and sell the securities in which it is registered for its own account on a regular or continuous basis, and (iii) publishes competitive, continuous two-sided quotations in its registered stocks in accordance with applicable SRO rules. This definition is consistent with market maker definitions in other Commission rules and incorporates SRO requirements as further controls. It would also exclude certain market professionals who are deemed market makers for purposes of the Commission's net capital rules, but who do not publish continuous two-sided quotations.
  
2. **Bona Fide Market Making Activity.** We recommend defining this term to cover transactions by a market maker as part of a course of dealing consistent with its obligations under the market maker definition, including activity to position the market maker's inventory for anticipated order flow. A skilled market maker will adjust its inventory to hedge anticipated changes in market conditions. For further clarity, the definition could set out that transactions relating to speculative selling strategies or investment decisions or that are disproportionate to the needs of the market (under a facts and circumstances analysis) *do not* constitute bona fide market making activity. This is comparable to the standard that the Commission proposes in Rule 203(b)(2) of Regulation SHO for a limited market maker exemption from the locate requirements, but with one important change: we believe that a market maker's trading activity should be evaluated in light of prevailing market conditions rather than its past trading patterns.<sup>11</sup>

These definitions would capture the safeguards against short selling abuses inherent in bona fide market making, obviating the need for the Commission to impose separate short sale restrictions on such trading activity. By focusing on the market maker function, this approach also has the advantage of avoiding unnecessary constraints on legitimate short selling by market makers that could seriously impair market liquidity. In the following sections we explain why certain proposed terms in Regulation SHO would have that unintended effect.

### C. **Uniform Bid Test**

#### 1. **The Commission Should Exempt Bona Fide Market Making Activity**

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<sup>11</sup> The Commission proposes to disqualify as legitimate market making activity trading that is disproportionate to a market maker's trading pattern. The problem with focusing on consistency with past trading activity is that it ignores the practical reality that market makers often have to adjust their trading when market conditions change. Many stocks have inconsistent trading patterns in terms of volume and volatility, which may require a market maker to engage in increased selling that appears to be disproportionate to its normal trading in order to fulfill its liquidity provider responsibilities. News announcements about a stock could generate a surge of buy orders that may result in legitimate variations to a market maker's historic selling patterns. If the Commission retains the proposed limited exemption in Rule 203(b)(2), we recommend revising this element of the rule's definition of bona fide market making to relate to trading activity that is disproportionate to the needs of the market based on a facts and circumstances analysis.

The Commission is proposing a short sale price test in Rule 201 of Regulation SHO, called the uniform bid test, which would apply to all exchange-listed and Nasdaq NMS stocks, wherever they are traded. Under this test, a short sale in a covered stock could occur only at a price at least 1¢ higher than the best bid reported for the stock on the consolidated tape at the time of the sale. Proposed Rule 201 would replace the current tick test under Commission Rule 10a-1 for listed stocks and the NASD bid test for Nasdaq NMS stocks under NASD Rule 3350.

The Commission's bid test poses special problems for Nasdaq market makers. The Commission is proposing a small number of narrow exemptions, but has decided at this time not to provide an exemption for bona fide market making activities. Its stated reason is that "a market maker should rarely need to sell short at or below the bid in its market making capacity."<sup>12</sup> We strongly disagree. Market makers routinely face trading conditions where they need the flexibility to, and do, sell to the bid to fulfill their market maker obligations. We wish to highlight three real life scenarios:

1. A market maker, in managing its inventory, needs the ability to sell short to the bid in a fast rising market. During dramatic upswings, a market maker may not be able to establish a large enough long position to avoid going short to satisfy customer demand. In this event, the market maker may wish to increase its short position at what it believes is the end of the upward run in order to increase its average price for the short position. When the prices start to level off, though, the market maker will likely only be able to sell short against the bid, as it becomes harder to find buyers willing to pay more than the bid. If the market maker is not allowed to do so, it will find it difficult to sell short at or near the high end of the run, thereby realizing a lower average price on its short sales and greatly increasing its risk of incurring a loss when it covers the short position. To illustrate, if a stock's price increases rapidly from \$20 to \$25, a market maker might realize an average short sale price for 100,000 shares at \$22.50, after selling shares to investors at all price increments, including \$21 and \$22. At this point, the market maker has an unrealized loss of \$250,000 as a result of providing liquidity to investors during the rising market. If the market maker believes the market has topped out at \$25, it may wish to sell short 50,000 additional shares at that price to increase its average price from \$22.50 to \$23.33. By doing so, the market maker could cover the short position at \$23.33, or lower, to avoid a serious trading loss if the market price goes down to that level. Restricting a market maker's flexibility to try to adjust its position at \$25 by selling to the bid will add to market making risk and cause a market maker to provide less liquidity during the stock's move from \$20 to \$25, at precisely the time it is most needed.
2. The bid test would also create substantial market inefficiencies when the market is locked or crossed, which the Commission's proposed trade through exemption would not

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<sup>12</sup> 68 FR 62989.

relieve.<sup>13</sup> For example, suppose a market maker is bidding at 20 and the market is falling. Another market maker that wishes to offer at 20 or less cannot hit the 20 bid if it has to sell short in order to do so. Moreover, anti-trust considerations preclude it from contacting the first market maker to ask it to change its aberrant quote.<sup>14</sup> The market maker is also effectively precluded by NASD rules from locking the market.<sup>15</sup> Even if the NASD changed its rules to permit a market maker to lock markets, the Commission's proposed trade through exemption would be unavailable to the market maker that initiates the lock. In short, the Commission's proposal will allow an inattentive market maker to interfere with efficient market functions with an off-market bid for as few as 100 shares and will likely result in more persistent locked and crossed markets.

3. Based on our experience, at times market makers need to be able to sell short at or below the bid to adjust their positions quickly in anticipation of changing market conditions. We believe that the Commission is too quick to dismiss the NASD's findings to this effect in its 1997 study analyzing the market maker exemption from the NASD's short sale rule.<sup>16</sup> The bid test will inhibit a market maker's ability to manage the timing of its inventory adjustments in a cost effective manner, potentially resulting in higher costs that will likely be passed on to investors in the form of higher spreads. For example, as an anticipatory hedge, a market maker may wish to short stock so that it is prepared to buy as much as prudently possible from expected sell orders.

We appreciate the Commission's concern that some NASD members may be taking advantage of the NASD's bid test exemption for Nasdaq market makers by "continuously [selling] short into the bid."<sup>17</sup> We believe, though, that this type of short selling is confined to a very small number of firms, with respect to the securities of a very small number of low-capitalized issuers. Moreover, the exemptive approach we recommend would address this problem. In our view, the trading pattern the Commission describes would be difficult to justify as bona fide market making activity, as the Commission has concluded.<sup>18</sup> Thus, the market maker could not rely

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<sup>13</sup> As the Commission is aware, Knight has long been concerned about the ongoing problem of locked and crossed markets. We have set out our concerns and recommendations in detail in testimony to the Congress and in a number of letters to the Commission and Nasdaq.

<sup>14</sup> This conduct is expressly prohibited under the Justice Department's settlement agreement with 24 OTC market maker firms reached in July 1996.

<sup>15</sup> NASD Rule 4613(e) sets this out for Nasdaq market makers. CQS market makers are subject to trade through restrictions under the ITS Plan. If a Nasdaq market maker enters a locking offer during the trading day into SuperMontage, the system converts it to a marketable limit order that takes its place in line to be executed against the bid it locks, putting the market maker in violation of the proposed bid test if its order is matched against that inside bid. NASD Rule 4710(b)(3).

<sup>16</sup> D. Timothy McCormick and Bram Zeigler, *The Nasdaq Short Sale Rule: Analysis of Market Quality Effects and The Market Maker Exemption*, NASD Economic Research (Aug. 7, 1997).

<sup>17</sup> 68 FR 62989.

<sup>18</sup> The Commission states that such trading is "inconsistent with bona fide market making." 68 FR 62989.

upon the exemption for those short sale transactions, and would face potential disciplinary action for violating the price test. We believe this more focused approach – enforcing the terms of carefully crafted exemptive criteria – is preferable to the Commission’s proposal, which punishes market makers that act responsibly for misconduct committed by the few that do not.

We urge the Commission to exempt bona fide market making activities from the application of any short sale price test. The elements we propose in the prior section for defining what constitutes bona fide market making activity will limit the exemptive relief to short sale transactions that are consistent with the market maker’s trading obligations.

## **2. The Commission Should Adopt a Less Restrictive Bid Test**

Knight believes that the proposed uniform bid test will prove much too restrictive for investors as well. If adopted, it will effectively prohibit customers from effecting short sales on market orders, because a market sell order by definition is intended to access immediate liquidity and thus is more often than not executed against the bid, not at a higher price. Thus, a customer wishing to sell an exchange-listed or Nasdaq NMS stock short will have to place a limit order to sell short priced 1¢ higher than the consolidated bid, but with no assurances that a market maker or any other market participant will agree to *pay more* than the consolidated best bid to take the other side of that order. This is especially a problem in a declining market, when it will often be impossible for a customer’s short sale order to be executed at a price higher than the bid. The Commission’s bid test is much more restrictive than the Commission believes. Moreover, forcing customers to place limit orders in order to sell short will be confusing, costly and make already thin markets even thinner by creating 1¢ spreads any time a customer wishes to sell short at the market.

Furthermore, as proposed, Regulation SHO will have the unintended effect of decreasing transparency in the marketplace. In the current trading environment, a buyer who enters a buy order better than the current bid but less than the offer has access to the supply of both long and short sellers (assuming for the listed stocks that the buyer’s price is a plus or zero-plus tick price). Under the proposed bid test, the buyer would only have access to the supply of long sellers, since short sellers would be forced to sell their stock a penny higher. Under such circumstances, the buyer may well conclude that its interests are better served by withholding its bid and instead waiting for a seller to place an order at its price, since both long and short sellers would have the right to place an order better than the bid. This scenario is unhealthy and a major step backwards for a market that prides itself on encouraging transparency, by discouraging investors from placing limit buy orders that improve the bid and add to depth of market.

We recommend that the Commission adopt a less restrictive bid test modeled after the NASD’s. Under this approach, a short sale in a covered stock could not occur at a price that is at or below the consolidated best bid for the stock when that bid is lower than the previous different best consolidated bid. When the consolidated best bid is higher than the previous different best consolidated bid, the stock could be sold short at any price. We believe it is appropriate not to impose any price restriction in that circumstance because the stock’s rising value minimizes the

opportunities for improper short selling activity. This approach is also consistent with the Commission's objective to "facilitate relatively unrestricted short selling in an advancing market."<sup>19</sup>

3. **The Commission Should Expand the Bid Test Exclusion For Bona Fide Arbitrage Transactions**

The Commission is proposing to retain the short sale exemption in Commission Rule 10a-1(e)(7) for bona fide arbitrage transactions, but with one important change. For arbitrage transactions involving convertible instruments or other rights to acquire securities, a short seller must subsequently acquire the underlying securities through exercise of the conversion right in order to qualify for the exemption.

Apart from the obvious problem of conditioning an exemption on the future activities of the short seller, this requirement ignores how arbitrage trading occurs. Market participants routinely sell out or adjust arbitrage positions. That does not invalidate the original arbitrage strategy or diminish the recognized benefits such activity provides to the markets by reducing price disparities between related securities. Nor does the Commission cite any reasons why it is necessary to impose this requirement, beyond stating that "it is consistent with" a prior interpretation of the current exemption.<sup>20</sup> Indeed, the Commission acknowledges that arbitrage activities "carry limited risk of the kind of manipulative or destabilizing trading that [its exiting short sale rule] was designed to address."<sup>21</sup>

The Commission should refrain from requiring a short seller to acquire securities underlying an arbitrage strategy as a condition to relying upon the bona fide arbitrage exemption. If this feature is retained, it will operate as a significant obstacle to legitimate arbitrage trading.

4. **The Commission Should Add an Exemption for Hedging by Options Market Makers**

We request the Commission to add an exemption from the short sale price test for hedging activity by options market makers comparable to the NASD's. NASD Rule 3350(h) allows an exchange-registered options market maker for a class of options on a Nasdaq NMS security to effect short sales in the underlying security to hedge an existing options position or an options position that it has established within the same brief time period as the short sale transaction, so

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<sup>19</sup> 68 FR 62980.

<sup>20</sup> 68 FR 62985, n.116. To our knowledge, the Commission has never expressly required securities underlying an arbitrage transaction to be acquired later through conversion as a condition for the bona fide arbitrage exemption in Rule 10a-1(e)(7).

<sup>21</sup> 68 FR 62985.

long as the market maker is eligible to receive good faith margin under Regulation T.<sup>22</sup> Derivative pricing is directly tied to the inside market of the underlying equity security. If an options market maker does not have access to one side of that inside market (i.e., the inside bid when short), then that will necessarily have an adverse impact on the pricing of the derivative. Thus, the NASD exemption promotes more efficient pricing of options on Nasdaq NMS securities and should be preserved and also extended to market makers for options on exchange-listed stocks.

## **5. Odd-Lot Transactions**

The Commission is proposing to incorporate into Regulation SHO the exemption for odd-lot transactions in Rule 10a-1(e)(3), and to expand the exemption to all market makers when acting as an odd-lot dealer. We agree with the decision to expand the exemption in this fashion.

### **D. Uniform Locate and Delivery Requirements**

#### **1. Proposed Uniform Locate Requirements**

The Commission is proposing locate and delivery requirements to reduce the occurrence of fails to deliver securities. Proposed Rule 203 would bar a broker-dealer from selling securities short for its own account or a customer account unless the firm or, if applicable, its customer has borrowed or made arrangements to borrow the securities or has reasonable grounds to believe that it can borrow and deliver them by the settlement date, subject to an exemption for market makers. Knight agrees that market makers should be exempted from the uniform locate requirement. As the Commission correctly notes, market makers need this relief to allow them to handle customer orders without delay in a fast market.

#### **2. Uniform Delivery Requirement**

In conjunction with the uniform locate requirement, the Commission is proposing strict delivery requirements with respect to any stock for which the number of undelivered shares within the clearing system equals 10,000 or more and constitutes ½% or more of the stock's total shares outstanding. When these circumstances exist, a broker-dealer, whether selling short on behalf of itself or a customer, must deliver the underlying shares within two days of the settlement date. If the shares are not delivered within this grace period, the short seller would be prohibited from effecting additional short sales in the stock for 90 days unless the seller has first arranged to borrow the security and then delivers the shares on the settlement date.

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<sup>22</sup> NASD Rule 3350(h)(2) allows market makers registered on an exchange with respect to stock index options classes to effect short sale hedging transactions in Nasdaq NMS stocks included in the index, subject to certain conditions, without the pricing constraint of its short sale bid test. We recommend that the Commission provide a comparable exemption for options market makers in proposed Regulation SHO with respect to all securities underlying the stock index.

The language of proposed Rule 203 appears to extend this 90-day trading restriction to proprietary trading by a broker-dealer that effects a short sale on behalf of a customer when the customer violates the delivery requirement. The discussion in the proposing release suggests, though, that the ban would apply to the customer only, which makes much more sense. We request clarification on this important issue, and urge the Commission to adopt the account specific approach. It would be grossly unfair to penalize the broker-dealer for short sale delivery violations committed by a customer.

We have several other comments. First, we recommend that the Commission adopt a market maker exemption from these requirements. As long as a market maker is performing bona fide market making activities, we see no reason why it should be forced to locate stock merely because it or its customer failed to deliver stock. In addition, without an exemption, market makers for stocks subject to the heightened delivery requirements will be hesitant to sell the stocks short in response to market need, due to uncertainty whether they can promptly offset those transactions under prevailing market conditions without substantial loss. In particular, this could have a significant impact on market makers for bulletin board stocks, which tend to be the most illiquid. A market maker in a thinly traded stock often takes on the risk of selling short to a periodic surge in buying interest, knowing that it might take considerable time, even months, to trade out of that position in an orderly fashion, without causing temporary price aberrations. The Commission's proposal which forces the market maker to cover its short position in the abbreviated timeframe with the threat of losing its market maker registration for 90 days if it does not, will greatly alter the market maker's risk-reward balance, likely tipping the scales against selling short to meet temporary imbalances in buying interest.<sup>23</sup> This loss of market maker liquidity will add to the volatility of stocks already highly prone to wide price swings due to their illiquid nature.

Second, we believe the proposed "fail to deliver" thresholds are much lower than necessary to protect against short squeezes in a security. The Commission states that it is using the same standards found in NASD Rule 11830 in support of its proposal. We believe that this is an apples to oranges comparison. The NASD uses the thresholds to identify stocks for which a short seller is subject to mandatory close out of its position if it fails to deliver the shares within 10 business days after the normal settlement date. That is a much different consequence than what the Commission is proposing. We recommend that the Commission instead adopt a standard under which the strict delivery requirements are triggered for a stock when the number of undelivered shares exceeds the greater of 30% of the stock's public float or 3 times the stock's average daily trading volume measured over a rolling four week period. For the first standard,

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<sup>23</sup> The Commission's proposal would also create an opportunity for prospective sellers to "squeeze" the market maker, by offering the stock at artificially high prices that the market maker has little choice but to accept due to regulatory time constraints. Apart from this concern, forcing market makers to cover short positions in such a short timeframe will result in greater price volatility as they seek to acquire shares of stocks often characterized by thin markets.

we recommend using a stock's float instead of the number of shares outstanding, because it is possible at least with smaller public companies for a large portion of the outstanding shares to be held subject to resale restrictions and thus not readily accessible. To implement this approach, we recommend that the Commission develop a definition of "float" that reflects the number of shares of a stock that are available for borrowing. In addition, the Commission should ensure that information on the size of a stock's float is readily available to the investing public. The Commission may also want to consider a mandatory close out requirement comparable to the NASD's. This would seem to be a much more direct and effective way to deal with the cited problem of delivery failures.

Third, we believe it is inappropriate to bar a person from effecting short sales in a stock for 90 days when it has complied with the locate requirement but is unable to deliver the securities within the two day grace period due to reasons outside its control. Another broker-dealer, for example, may mistakenly say it has securities to lend when it does not. This issue is of even greater concern if a violation by a broker-dealer's customer is attributed to the broker-dealer; the broker-dealer should be allowed to rely upon its customer's reasonable assurance that it will borrow and deliver the securities on time. The Commission should excuse inadvertent non-compliance from application of the 90 day ban and restrictions.

Fourth, we recommend that the Commission extend the grace period to five business days. At the very least, the grace period should be measured in *business* days, not calendar days, to provide a meaningful opportunity to correct a delivery failure that may occur on a Friday or the day before a market holiday.

Finally, we request clarification on how the delivery requirement would work in the context of the rolling position over in the continuous net settlement process in which all clearing firms operate.

#### **E. Determining Short Positions**

##### **1. Unconditional Contracts to Purchase Securities**

The Commission is proposing to adopt a definition of "short sale" using the definition in Commission Rule 3b-3, with some amendments. Currently, Rule 3b-3 allows a party to an unconditional contract to purchase shares of a security to claim ownership of the shares before receiving them for purposes of calculating whether it has a net long or short position. The Commission has raised whether it should add as a requirement that the contract must specify the price and amount of shares being purchased for the contract to be deemed "unconditional" and the purchaser to be deemed to own the shares.

Knight recommends against adoption of the proposed fixed-price requirement. Purchase contracts that tie the price of a trade to a future event or measure are often used as a means for investors to execute large transactions without causing temporary price spikes, and thus serve a useful market purpose. For example, one common pricing mechanism is to use a security's

volume weighted average price ("VWAP"), which is determined after the market closes. VWAP contracts are routinely treated as establishing ownership of the shares for the buyer, in reliance on a reasonable reading of Rule 3b-3. If the Commission imposes a fixed-price requirement, it will discourage the use of VWAP contracts and other types of variable price contracts for which there is legitimate investor demand.

Such a requirement would also foreclose an avenue for a market maker to purchase securities to establish a long position in a registered stock. This is of concern if market makers will be subject to the bid test and delivery requirements when acting in their market maker capacity.

## **2. Aggregation Units**

Knight agrees with the Commission's proposal to incorporate the terms of the Commission staff no-action letter issued in 1998 allowing multi-service broker-dealer firms to determine net long or short positions in a stock by aggregation unit. As a condition for this relief, a broker-dealer must determine each aggregation unit's net position in a stock on a continuous, real-time basis. As proposed, Regulation SHO does not address whether a broker-dealer without aggregation units must calculate its firm-wide positions on a real-time basis. We request clarification on this point.

## **III. Conclusion**

Proposed Regulation SHO, if adopted in its current form, will seriously undermine the ability of Nasdaq market makers to provide liquidity in their registered stocks by eliminating their flexibility to sell short to enable them to fulfill their market making responsibilities and by greatly increasing their costs. The risk is particularly grave for market makers in less liquid stocks, which put their capital at risk daily to provide continuous two-sided quotes in markets in which it is proving more and more difficult to turn a reasonable profit for the risks assumed. Knight urges the Commission to exempt bona fide market making from the various restrictions proposed in Regulation SHO, including the proposed bid test and delivery requirements. The definitions of "market maker" and "bona fide market making" that we propose will provide appropriate constraints on market maker short selling practices inherent in the standards a market maker must follow to fulfill its trading obligations, and avoid the "sledge hammer" approach embodied in Regulation SHO of restricting legitimate market making activity to target abusive practices committed by a small number of market makers. We also urge the Commission to adopt the other changes we recommend.

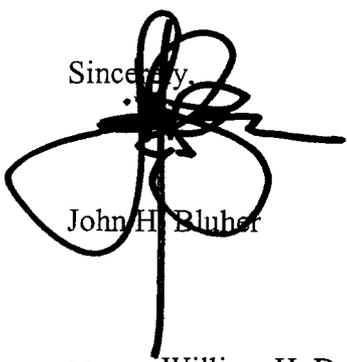
Mr. Jonathan G. Katz

January 6, 2004

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We would be happy to discuss our comments with the Commission.

Sincerely,



John H. Bluber

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