June 19, 2009

Submitted via rule-comments@sec.gov

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Release No. 34-59748; File No. S7-08-09
Amendments to Regulation SHO

Dear Ms. Murphy:

Wolverine Trading, LLC and its affiliates welcome this opportunity to comment on the proposal by the Securities and Exchange Commission ("SEC" or "Commission") to make amendments to Regulation SHO ("Reg SHO")[1] by implementing a price test or a circuit breaker[2] (the "Rule Proposals").

By way of background, Wolverine Trading, LLC ("Wolverine Trading") acts as a market maker on every U.S. options exchange and several U.S. equities exchanges. As a registered market maker, Wolverine Trading provides liquidity in the majority of listed equity and index options and exchange traded funds ("ETFs"). Wolverine Execution Services, LLC ("WEX") provides electronic routing and execution services for institutional customers on all U.S. options exchanges and most U.S. equity exchanges. Wolverine Asset Management, LLC ("WAM") manages a hedge fund that primarily engages in a convertible arbitrage strategy. Finally, Wolverine Capital Markets, LLC ("WCM") provides execution services to institutional customers on the floor of the New York Stock Exchange.

Although we have the utmost respect for the Commission and the burden it bears in formulating reasonable regulations designed to prevent abusive practices within the marketplace, we believe the Commission should proceed with extreme caution and diligence prior to enacting any changes that would limit a market participant's ability to provide or take liquidity in the U.S.

[1] 17 CFR §242.200, *et seq.*

[2] The Commission proposes to implement certain restrictions on short selling activities only after a severe price decline for a security, herein referred to as a "circuit breaker."

financial markets. The Proposed Rule has broad implications for all market participants, including all of the Wolverine entities. For example:

- As an options and ETF market maker, Wolverine Trading is subject to various mandatory regulatory obligations. Chief among these, the firm is required to post continuous, two-sided markets in the options and stocks in which it makes a market. Wolverine Trading also may route orders as part of its market making activities. Whenever the firm makes a trade, the firm assumes additional risk – either on the long or short side of the market. This risk must be managed in order for the firm to continue to provide liquidity. The only practical alternative for hedging options risk is through the purchase or sale of underlying or related stock. We believe the Commission recognized the importance of the use of stock as a hedging tool for market makers when it issued its emergency order September 18, 2008 (the "Order")[3] banning short sales in certain financial stocks because the Commission included an exemption for market makers from the restriction on short sales. Any limitation on the short selling of stock, such as those in the current Rule Proposals, would lead to less liquidity and wider spreads in the options market because of the limited ability to hedge with the underlying security.

- As an asset manager, WAM engages in a convertible arbitrage strategy. The convertible bond market in the U.S. is one of the largest in the world in terms of market capitalization. When the Commission issued its Order, it had the effect (unintended, we assume) of virtually shutting down the convertible bond market. The market was decimated as a result. Furthermore, the Order directly led to several other negative consequences – companies couldn't issue new convertible debt at a time when it was most needed and institutional investors, including those representing pension plans and plan assets, lost billions of dollars because fund managers couldn't hedge bond positions or enter into new deals due to the extreme lack of liquidity. Any new limitations on the short sale of stock would only serve as a major setback to a marketplace that has seen positive rebounds since the Order was lifted.

- As a routing broker, WEX routes an average of over one million equity orders each trading day to the exchanges on behalf of its customers. The effects of the Rule Proposal as it relates to WEX vary from minimal to extreme depending upon which iteration of the Rule Proposal (if any) is adopted by the Commission. In a worst case scenario, WEX would need to spend no less than six months and a half a million dollars to make changes preventing customers from entering orders that would violate price tests. Furthermore, WEX would have to devote significant additional resources to annual maintenance and to

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[3] Securities Exchange Act of 1934 ("Exchange Act") Release No. 34-58592, Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments.

> the supervision of the entry and routing of short sales – all on top of the dozens of other supervisory responsibilities to which it is subject as a member of the exchanges and the Financial Industry Regulatory Authority.

Based on the above summary – which we believe is representative of a wide spectrum of the financial markets – it is apparent that the Rule Proposals would have negative consequences, both intended and unintended, on most market participants. Accordingly, Wolverine does not support any of the alternatives outlined by the Commission in the Rule Proposals. As discussed further below, past studies by both the Commission and various independent parties indicate that short sale restrictions are not necessary and ultimately do not serve their intended purpose. As a result of this, Wolverine believes that the Rule Proposals would yield negligible effects beyond the short sale regulations already adopted by the Commission.[4] Furthermore, Wolverine believes that the implementation of circuit breakers or price tests in today's equity marketplace – a primarily electronic marketplace with ten national securities exchanges, 47 alternative trading systems, 325 firms registered as equity market makers or specialists that are considered "non-SRO trading centers" and 5,561 registered broker-dealers[5] – could lead to mass confusion over timing differences and the appropriate benchmark price against which to determine whether there has been an uptick, a downtick, an upbid or a downbid. Finally, Wolverine believes that the potentially exorbitant market-wide implementation costs, the reduction in market efficiency and the added regulatory burden on market participants, the Commission and self-regulatory organizations ("SROs") far outweigh any perceived benefits from the enactment of any of the Rule Proposals.

<u>Previous Short Sale Restrictions – Rule 10a-1</u>
Following a brief, two-week study by the Commission of twenty listed securities, the restrictions of Rule 10a-1[6] were implemented by the SEC in 1938 and were designed to restrict short selling in a declining market. Although implemented in a time well before the electronic marketplace that exists today, Rule 10a-1 remained relatively unchanged during its existence, although the SEC granted numerous exemptions during the almost seventy years of its effectiveness. Beginning in 2005, the Commission implemented a pilot program in which price tests of certain securities were suspended as a means to judge the continued need for Rule 10a-1.[7] The results of

[4] *See* Exchange Act Release No. 58572 (September 17, 2008), 73 FR 54875 (September 23, 2008) whereby the Commission enacted Rule 204T under Regulation SHO with immediate effectiveness. Rule 204T required the mandatory delivery of stock for short sales in all stocks. *See also* Exchange Act Release No. 58774 (October 14, 2009), 73 FR 61677 (Oct. 17, 2008), implementation of the "Naked" Short Selling Antifraud Rule.

[5] Exchange Act Release No. 34-59748, p. 169.

[6] 17 CFR 240.10a-1

[7] See Exchange Act Release No. 34-50103 (July 28, 2004).

the pilot program were summarized in a report issued by the Commission's Office of Economic Analysis ("OEA") on February 12, 2007 (the "Report"). In the Report, the Commission indicated that trading in listed stocks was "more balanced when the tick test does not apply."[8] These findings are relatively consistent with a paper issued by academics from the Yale School of Management in January 2003 where the researchers noted that "[d]espite the relationship between short sales constraints and skewness at the individual security level, we find little compelling evidence that short–sales constraints prevent or mitigate severe price declines at the market level. In particular, we do not find that short–sales constraints prevent market crashes."[9] Paralleling recent events, this paper also made reference to the global economic issues faced in 1997 during the Asian currency crisis in which "short-sellers were blamed by politicians and journalists for helping destroy the 'Asian Miracle.'" The paper further addressed previous support by the academic community that made the case for permitting short selling, and their support for "the hypothesis that difficulty in short selling is associated with security mispricing."[10]

The OEA Report further provided an overview of previous studies, conducted both by independent parties and by the Commission, in which the results presented little or no evidence that the existing price tests offered protection against market declines. Rather, the studies demonstrated that the entry of short sales where a price test existed resulted in "execution delays and lower fill rates."[11] Given the current proliferation of trading volume in a mostly electronic trading world – resulting in part from the onset of multiple listing, customers' need for fast executions, the need to comply with various regulatory obligations and the entrepreneurial efforts of sophisticated market participants – Wolverine believes that if any of the Rule Proposals are adopted, "execution delays and lower fill rates" would return and result in even greater inefficiencies for all market participants.

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[8] During the course of the initial pilot program, The NASDAQ Stock Market, LLC ("NASDAQ"), was not an exchange registered pursuant to Section 6 of the Exchange Act. Additionally, NASDAQ employed a separate price test, a "bid test," to serve the purpose of preventing short selling in a declining market. Therefore, securities listed on NASDAQ were compared separately by the Office of Economic Analysis; however, removal of the bid test during the pilot showed a decline in the percentage of time in which the market was in a downbid.

[9] *See* Efficiency and the Bear: Short Sales and Markets around the World, dated January 2003, by Arturo Bris, William N. Goetzmann, and Ning Zhu of the Yale School of Management.

[10] *Id* at 27.

[11] *See* OEA Economic Analysis of the Short Sale Price Restrictions Under the Regulation SHO Pilot, February 6, 2007, p. 20.

In July 2007, the SEC amended Regulation SHO,[12] rescinded Rule 10a-1 and prohibited any marketplace from having a price test. As stated in the amendment's proposal, the amendments were "designed to modernize and simplify short sale regulation and, at the same time, provide greater regulatory consistency by removing restrictions where they no longer appear effective or necessary." Despite the rescission of 10a-1, the Commission issued the Order following significant price declines in certain financial securities in the fall of 2008.[13] The Order prevented short selling in approximately 800 publicly traded securities of certain financial firms during the period from September 19, 2008 through October 8, 2008. When we reviewed price data for a very limited sample of securities affected by the Order, which was hastily issued without input from liquidity providers, asset managers or other users of the financial markets, we noted that the Order did little to curb further significant declines in certain financial stocks.[14]

The Rule Proposals

As noted above, Wolverine supports none of the alternatives offered by the Commission in the Rule Proposals. Simply put, the reimplementation of price or bid tests is unnecessary based on previous studies that have demonstrated that they ultimately do not achieve the desired effect. Reimplementation of any similar regulations would provide no real substantive benefit to anyone, but would increase confusion, costs and burdens for everyone.

The Commission's proposal to implement a circuit breaker with a trading halt is a much narrower alternative because restrictions would only be enacted on a stock-by-stock basis after a "significant" decrease in value. Furthermore, it appears that this alternative would greatly reduce the need for complicated procedures to monitor for compliance with short sale restrictions. Nevertheless, we believe any trading halt in a security is the least desirable alternative. When trading is halted, there is no trading, no quoting, no price discovery and no ability to manage the risk associated with existing positions. Furthermore, the imposition of a halt, or the belief that a halt is imminent, may cause an unintended surge in short sale orders just prior to the halt. Additionally, there is the unknown associated with pricing immediately following the removal of the halt. Extreme volatility could cause even more drastic price movements. We believe that this would have the opposite intended effect of the Rule Proposals.

Rule 204T (the "Close-out Rule"), which was enacted in September 2008, already addresses many of the Commission's concerns with respect to short sales, particularly those related to

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[12] *See* Exchange Act Release No. 55970 (June 28, 2007), 72 FR 36348 (July 3, 2007).

[13] The Commission took several lesser actions prior to the ban in an effort to curb short selling.

[14] For example, the price of Bank of America Corporation (NYSE: BAC) further declined 21% during the effectiveness of the Order.

alleged "abusive" or "naked" short selling. 204T requires that short sellers and their broker-dealers deliver securities by the close of business on the settlement date (three days after the sale transaction date, or T+3) and imposes penalties for failure to do so. Fail to deliver positions related to bona fide market making or long sales have an additional two settlement days to close-out fail to deliver positions. Unlike the original version of Reg SHO, which only applied to "threshold securities," Rule 204T applies to all equity securities. Based on the Commission's own analysis, fails to deliver were reduced significantly after the implementation of the Close-out Rule.[15] In fact, OEA noted a 47.2% decline in fails across all securities, a 63% decline in fails in threshold securities and in general, a large downward trend in fails since July 2008.[16]

In addition to the Close-out Rule, the Commission also implemented new anti-fraud provisions – Rule 10b-21 – on September 17, 2008 with the intent of imposing "powerful disincentives to those who might otherwise exacerbate artificial price movements through 'naked' short selling."[17] We believe that between the costs and burdens on market participants associated with mandatory close-outs in all equity securities and the potential threat of fraud charges for short sales conducted in contravention of the federal securities laws, the Commission already has a substantial arsenal in place to combat any "abusive" acts by short sellers.

Costs to Implement and Regulatory Burdens

In the Rule Proposals, the Commission sought comments on the costs and burdens associated with the implementation of the Rule Proposals. We admit that we found the Commission's analysis confusing regarding what the Commission believes the costs would be for market participants to implement or comply with the Rule Proposals. Nevertheless, under no circumstances should the burden of enforcing price or bid tests be placed on market participants that send orders to or execute orders on the exchanges or market centers. We agree that all participants that send orders for execution should be responsible for accurately representing whether an order is a long sale or a short sale. But that's where the obligations must end.

We are both weary and wary of regulations that are retrospective in nature and that seek to place additional regulatory burdens and enforcement obligations on firms. One of the Commission's primary goals is to prevent rule violations; however, if the onus for determining whether or not an order is being executed in accordance with any of the Rule Proposals is placed on the over 5,000 registered broker-dealers that may send orders to an exchange or market center, there will never be full compliance with the Rule Proposals. On the other hand, if the exchanges and market centers are enforcing the Rule Proposals, there should always be 100% compliance with a

[15] OEA Memorandum, Impact of Recent SHO Rule Changes on Fails to Deliver, March 20, 2009.

[16] *Id*, p. 1.

[17] Exchange Act Release No. 34-58572, p. 3.

circuit breaker or bid or price test because the exchange/market center makes the ultimate determination as to whether an execution complies with regulatory requirements. We believe this should be done by the exchanges and market centers prospectively as gatekeepers and regulators of the markets (i.e., before orders are let in the door) and not retrospectively as enforcers of rule violations that they could have wholly prevented in the first place.

We undertook a review of what it would cost to develop and implement systems changes in the event the Commissions expected broker-dealers to enforce circuit breakers or price tests when routing orders. Between development man-hours, hardware costs and the purchase of additional costly data feeds, it would take approximately six moths and no less that $500,000 each for our market making entity and order routing entity to make changes to prevent the routing or execution of orders that would violate a circuit breaker or price test. Furthermore, it would cost an estimated $20,000 annually to maintain the system. If all 382 entities considered "non-SRO trading centers" would be required to enforce the Rule Proposals, the cost would be $191,000,000.[18] If the Commission meant to imply that all 5,561 registered broker-dealers have to implement similar changes, the total would balloon to over $2,780,500,000. Added costs associated with developing appropriate internal supervisory procedures and compliance programs, the increased costs to regulators for additional enforcement needs and the inevitable monetary fines further increase the cost burden by a substantial dollar amount.

As noted above, there are ten exchanges and an additional 47 ATSs on which stocks are traded – a number that represents approximately 1% of the total number of registered broker-dealers. If the costs to amend their systems to account for the Rule Proposals are similar to those mentioned above, the total dollar amount for these changes would be approximately $28,500,000, an amount that is relatively inexpensive when compared to what it would cost all non-SRO trading centers and broker-dealers. Perhaps most significantly are the costs going forward for the exchanges and ATSs, i.e., they should be minimal because they would be limited to system testing and maintenance, not the regulation of hundreds of members' systems, procedures and trading activity. Finally, we would stress that in the recent past, the exchanges were responsible for the enforcement of the limitations established by 10a-1 and they made the determination as to when, whether and at what prices short sale orders were executed. Because the exchanges have had the infrastructure in place to handle price tests and circuit breakers, it would make the most sense for them simply to reinstate that infrastructure with any relevant modifications to account for the Rule Proposals.

Finally, we foresee significant confusion over pricing and quote latency and speed issues that will be unavoidable if every non-SRO market center and broker-dealer is required to enforce the Rule Proposals. Right now, participants receive their data from different sources at varying costs

[18] Based on our estimate of $500,000.

and decisions to trade are made based on that data. Would the implementation of a plan mandating universal enforcement of the Rule Proposals force everyone to use the same market data? What costs would be associated with any such data feed? As the most practical alternative, we would note that the exchanges have an obligation to provide a fair and orderly marketplace for all market participants and placing the burden for the implementation of the Rule Proposals on this limited number of entities will ensure that the fairest executions for every market participant if any of the Rule Proposals are approved.

<u>The Need for Liquidity Providers Volatile Periods</u>

During the unprecedented volatility experienced in the fall of 2008, the need for liquidity providers, e.g., market makers, was more apparent than ever. According to statistics maintained by the Options Clearing Corporation ("OCC"), customer contract volume in certain financial securities increased by more than 2,500% during the period in which the short sale ban was in effect in comparison to volume during the same period in 2007. Specifically, on September 19, 2007, the total volume of contracts in options of American International Group, Inc. (NYSE: AIG) marked as "customer" was 14,733. The volume of customer contracts of AIG on September 19, 2008, was 386,407. Similarly, the volume of customer options contracts for Wachovia Corporation (NYSE: WB) during the entire time the Order was in force was 3,133,840, an 1,174% increase from the 246,668 customer contracts for the same period one year earlier. These are just two examples that provide clear evidence of the fact that in times of extreme volatility, options are an important tool used by customers. The reimplementation of a bid/price test in the equity markets not only would limit customers' access to equities, it also would reduce their access to options because market makers' ability to provide liquidity would be impaired.

We also noted a significant correlation between customer and market maker contract volume during and around the time the Order was in effect. Specifically, we noted on the OCC's website that during the fourteen business days prior to the effectiveness of the Order, the ratio of market maker to customer option orders in JPMorgan Chase & Co. (NYSE: JPM) was approximately 1.53:1. During the period of the Order's effectiveness, this ratio lowered to 1.18:1, while the put to call ratio for JPM contracts increased from 0.91:1 to 1.37:1 during this same period. We believe these statistics demonstrate a higher demand for options by customers, and therefore, a greater need for market makers to provide liquidity during a period of extreme volatility. It should be noted the daily market maker to customer order correlation during the time period immediately prior to the Order's implementation (September 17, 2008 through September 19, 2008) in AIG was significantly lower – 0.31:1. It would appear that as fear among market makers increased over worries that a short sale ban was imminent, market makers were unable to provide nearly as much liquidity in options because of the potential inability to hedge outstanding or additional positions with short stock.

The role of market makers and the competition that continually exists between them to improve market prices and tighten spreads contributes to price discovery and liquidity when customer orders are presented. We believe these statistics illustrate the important role options market makers served during the time the Order was in force – a period of high demand by customers. Furthermore, we believe these statistics demonstrate that if short sales are restricted, liquidity may be greatly reduced in the options market.

Other Areas of Focus

We have to wonder if the Commission set its sights on the right target when it issued the Rule Proposals. The plan to institute circuit breakers or to reinstitute a price test in the equities markets feels like a reactionary move in the wake of the market's collapse last fall. Arguably, a major culprit behind the recent market decline was not short selling, but rather, the lending practices of banks and other lenders in an extreme housing market. Add inexpensive credit to the mix and the willingness of other entities to assume the risk of sub-prime loans, and a foundation for a significant market decline was firmly in place.

On the other hand, while the removal of price tests preceded the market decline of 2008 by one year, it did not immediately precede those events, and no studies or data exist that demonstrate that the rescission of Rule 10a-1 had any material effect on recent market activity. Moreover, we agree with recent statements by some Commissioners who reiterated that lengthy and detailed studies were undertaken prior to the elimination of 10a-1, and that the benefits of any future restrictions must exceed the implementation and opportunity costs associated with implementing future restrictions.[19] More specifically, we agree with the comments of Commissioner Aguilar that addressed the need for comprehensive regulation – but not the regulations described in the Rule Proposals, which we believe will be ineffective as a means to stop future significant declines in the equity markets. Short selling serves a legitimate purpose in the marketplace and regulation should not have the effect or purpose of artificially supporting or inflating market prices. Nor should any regulation delay price discovery through impediments such as price tests or circuit breakers. The recent global crisis was not caused by short selling, but by other factors that simply are not addressed by the Rule Proposals.

Publicly traded companies have failed and will continue to fail in the future, regardless of overall market conditions. When several financial institutions recently went bankrupt or accepted federal assistance to remain in business, the events leading to their financial circumstances didn't happen overnight – they were years in the making. To the extent that financial reporting was faulty or that disclosures were not made indicating that disaster was imminent or that appropriate risk controls were not in place should be the areas of focus for future regulations. The Securities

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[19] *See* Statements by Commissioners Casey and Aguilar before the Commission open meeting on April 8, 2009, regarding the Rule Proposals.

Exchange Act of 1933 was enacted to ensure full and fair disclosure of all material information in the offering process. Since that time, the disclosure of accurate, material information to the marketplace has been a cornerstone of the U.S. securities markets. When information is misleading, underreported or manipulated, or other events occur that simply cause a company to become distressed, there is no way around an imminent negative impact on the marketplace. A limitation on short sales will only delay, not prevent, the inevitable correction that follows.

Conclusion

Now more than ever, the Commission has to strike a balance between protecting market participants and allowing market forces to establish prices – on both the long and short sides of the market. Because the Rule Proposals restrict short selling, the amendments could result in overvalued stocks as well as a substantial reduction in the ability of market participants to effect transactions in equity stocks and in the options overlying stocks. As noted during the time the Order was in force, restrictions on short selling could have a severe impact on certain trading strategies with catastrophic results. Additionally, regulations implemented at the end of 2008 (e.g., 204T) already address the Commission's concerns in relation to short selling. Finally, the negligible benefits from short sale limitations do not justify the confusion, added costs and regulatory burdens that will fall on market participants. Therefore, we respectfully request that the Commission take no action with respect to the Rule Proposals.

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We thank the Commission for this opportunity to present our views and would welcome the opportunity to discuss this matter further.

Sincerely,

Megan A. Flaherty
Chief Legal Counsel
Wolverine Trading, LLC
Wolverine Asset Management, LLC
Wolverine Execution Services, LLC
Wolverine Capital Markets, LLC