Lime Brokerage

September 21, 2009

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

RE: File No. S7-08-09; Proposed Amendments to Regulation SHO as Amended

Dear Ms. Murphy:

Lime Brokerage LLC welcomes the opportunity to provide supplemental comment on the additional proposed rule amendments to Regulation SHO, in which the SEC requests feedback on an alternative price test ("Alternative Uptick Rule") as a potential approach to restricting short selling activity in the US Equity markets. Lime Brokerage LLC ("Lime") is a technologically advanced brokerage firm that caters to a diverse and sophisticated customer base. Lime's clients include professional traders, hedge funds, asset managers and other broker-dealers. Our customers rely on Lime's robust and advanced technology to execute equities transactions on multiple exchanges, ECNs and trading venues.

1. Background

When evaluating proposed solutions, it is important to understand the exact nature of the problem that is being addressed by the solution. We believe there are, in fact, two separate and distinct problems relating to short sales facing the US Equity markets.

- Naked short selling
- Short selling occurring during market dislocations, causing stock prices to fall rapidly and uncontrollably

Actions taken over the past year by the Commission have been very effective in addressing the naked short selling issue. The implementation of Rules 204T and Rule 10b-21 have had a positive effect on this disruptive practice. Additional action in this area can move us closer to the ultimate goal of complete elimination of naked short selling. We provide some thoughts on how this can be achieved.

The Commission is also faced with the task of finding an effective mechanism to address the "free fall" of a stock in a panic situation. We have addressed the recent proposed amendments to Regulation SHO from the perspective of identifying the best possible method to solve this problem.

2. We Reiterate our Position as Detailed in our Earlier Comment Letter

Without restating the contents in detail here, we include by reference the positions outlined in our Comment Letter dated June 19, 2009[1]:

- **The Commission Should Support Regulation That Will be Effective in Curtailing Abusive Short Selling While Maintaining the Beneficial Elements that Legal Short Selling Brings to the Marketplace**
    - Existing Regulation Can Provide Sufficient Oversight to Short Selling
    - Empirical Evidence Supports the Use of Existing Regulations to Curb Manipulative Behavior and does Not Support the Imposition of Price Tests
    - Proposed Short Sale Restrictions Will Have Unintended Consequences and Impact Beneficial Short Selling Activity
- **Price Test Rules are Not Effective When Broadly Applied Due To Varied Latencies in Delivery**
- **If the SEC Proceeds with Implementing Regulation, We Believe that the Circuit Breaker Halt Proposal is the Least Disruptive Mechanism for Promulgating Fair and Orderly Markets**
- **Short Sale Regulation Should Be Applied Equally to All Market Participants**

3. Additional Action is Required to Eliminate Naked Short Selling

Although not explicitly the subject of this proposal, we believe that consideration must be given to the impact of naked short selling on investor confidence and market efficiency in addition to the mechanics of executing short sale orders.

a. Regulators must Visibly Enforce Regulation Regarding Naked Short Selling

Through stricter enforcement of existing rules, as well as the introduction of additional provisions of Regulation SHO, significant progress has been made towards elimination of naked short selling. As reported by the SEC in the Release making the provisions of temporary Rule 204T permanent[2], after the introduction of Rule 204T the average daily number of fails to deliver for equity securities declined by over 56%, and the average daily number of threshold securities declined by over 77%.

Although the steps taken to date have helped the situation, we believe additional efforts are required to address the potential "multiplier" effect that exists when short sellers rely upon a single locate to effect multiple short sales. More stringent close-out requirements must be

[1] Letter from Jeffrey S. Wecker, CEO, Lime Brokerage LLC, to Elizabeth M. Murphy dated June 19, 2009
[2] Exchange Act Release No. 34-60388 (July 27, 2009), 74 FR 38265 (July 31, 2009)

forcefully policed to ensure compliance. We believe these requirements provide a significant deterrent to naked short selling activity, but will become less effective if not visibly and consistently enforced.

b. Exemptions to Regulation SHO Should be Reviewed to Ensure they do not Provide Mechanisms to Undermine the Goal of Eliminating Naked Short Selling

We urge the Commission to review the effect of the Broker-Dealer market-making exemption to the Borrowing and Delivery Requirements of Regulation SHO[3] on the reduction of naked short selling activity. This exemption provides a certain class of market participants the ability to conduct short selling activity without the requirement of obtaining a locate. Additionally, the close-out requirements of Rule 204 provide an extended timeframe for this same class of participants to address a fail-to-deliver situation.[4] Both of these provisions could be contributing to the ongoing naked short selling activity in the market.

We believe that in order to be completely effective, regulation must apply equally to all market participants to the extent possible while at the same time ensuring efficient operation of the markets. Exemptions granted to classes of participants or behaviors should be analyzed carefully to ensure that they do not provide loopholes that unnecessarily thwart the goals of the regulation.

4. Price Tests Governing Trading in US Equities are Not the Most Effective Mechanism to Combat Short Selling in a Panic Scenario

a. The Proposed Circuit Breaker Halt Solution Will Provide the Market with a "Cooling Off" Period without the Negative Consequences of a Permanent, Market-Wide Restriction

Focusing on the ultimate goal of preventing a significant negative market disruption resulting from a panic, we believe that the stock-specific, exception-based Circuit Breaker Halt will provide the required interruption of a degenerating market and offer support for a controlled return to normal market conditions. We believe there are many benefits to this approach:

- It addresses a specific situation in which a given instrument is experiencing unusual market pressures rather than affecting all trading across the board
- It is temporary rather than in effect even when markets are operating efficiently
- It reduces or eliminates the need for unfair and exploitable exemptions for particular classes of market participants
- It is operationally simpler for the industry to implement

b. Implementation of Price Tests Exclusively in the Equity Markets may Create Arbitrage Opportunities with Derivative Instruments

[3] Rule 203(b)(2)(iii) of Regulation SHO [17 CFR 242.203]
[4] Rule 204(a)(3) of Regulation SHO [17 CFR 242.204]

If regulation attempting to curb dislocative downward pressure on a stock is implemented exclusively in the US Equity markets, regulators risk an outcome in which unfettered selling activity merely shifts to derivative markets with equal, if not higher, detrimental effects. It Many derivative instruments exist which can achieve the same effect as a short sale, and in many cases require less capital from the participant making the trade. Options strategies, futures, short ETFs and credit default swaps are all instruments that can be used to synthesize a short position without restriction under the proposed regime. Ironically, purchases of short ETFs may require dealers to short the underlying equity instruments – taking advantage of the market making exemption described earlier. This could lead to additional naked shorting by those participants – clearly exacerbating rather than ameliorating the naked short selling issue.

c. Price Tests that Regulate Trading in Downward Markets Display a Regulatory Bias Towards Rising Markets

The goal of regulation of the US Equity marketplace should be to ensure fair and orderly markets that operate in an efficient manner. It is critical that regulators take an approach that does not attempt to influence the actual prices at which securities transactions are effected while attempting to achieve operational objectives. Restricting prices at which securities can be transacted in a market moving downwards, but having no such restrictions on a market that is rising, incorporates what we believe to be an inappropriate directional bias into regulation that should instead be focused on curtailing abusive behavior.

A directional bias in markets could impact the perception of the fairness of the US Equity Market structure on the part of issuing companies and traders around the world. This could create a shift in market share away from the US Equity Markets in favor of other markets that are viewed as more objective in their regulatory structure.

5. The Proposed Alternative Uptick Rule Does not Address the Deficiencies of Price Tests and Would Introduce Significant Additional Barriers to Liquidity and Unintended Consequences

a. Variations in Infrastructure Quality and Sources of Data Will Lead to Inconsistent Views of the Current National Best Bid Across Market Participants

As detailed in our prior comment letter, we believe that a Price Test relying on all participants to have a consistent view of the current state of the National Best Bid is fundamentally flawed. Market participants receive data from a variety of sources: sometimes directly from exchanges, sometimes from vendors that perform consolidation. Lime has observed over 10 times the latency between SIP data and direct exchange feeds in one case. We are concerned that participants will be provided with an opportunity for 'data feed arbitrage' to leverage the different prices that could be received from different vendors at any given time.

b. Allowing Short Selling to Occur Only on a Passive Basis will Have an Immediate and Unfavorable Impact on Market Liquidity and Pricing Efficiency

Lime believes that the proposed Alternative Uptick Rule is the least attractive of the Price Test options that are under consideration by the Commission. Eliminating the ability of a

Short Sale order to "hit the bid" at the prevailing national best bid price will have a significant negative impact on liquidity. As noted in the proposal, "the alternative uptick rule would not allow short sales to get immediate execution, even in an advancing market...It could also potentially lessen some of the benefits of legitimate short selling, including market liquidity and pricing efficiency to a greater extent"[5] than the other price test proposals. We strongly believe that there will be a detrimental impact on quote depths, spread widths, market liquidity, execution and pricing efficiency if this proposal is adopted.

Lime analyzed the potential impact to its clients' trading activity of this proposed price test. We observed that, among our virtual market maker clients, approximately 25% of the short sales that were transacted over the course of a sample month would have been prohibited if the alternative uptick rule were in place. That represents what we believe to be an unacceptable impediment to market efficiency.

c. While Reducing Some Implementation Requirements, the Alternative Uptick Rule as Proposed does not Significantly Modify the Implementation Burden as Compared to Other Price Test Proposals

While we appreciate that the implementation burden of the Alternative Uptick Rule on certain participants, such as Exchanges, may be significantly lower as compared to the earlier proposals involving Price Tests, the burden on other participants will be similar, if not greater.

As an agency-only broker-dealer, Lime's primary implementation concern with respect to this proposal will be related to re-implementation of 'Short Sale Exempt' order types in interfaces between Lime and our Customers as well as the venues that support such exempt order types if such exemptions are re-implemented; updates to supervisory procedures to reflect the new rules, and education to our client base.

However, we believe that the key impact will be to our clients who will necessarily have to make significant alterations to their trading models to incorporate this new regulatory structure. As described above, the level of uncertainty introduced by the Alternative Uptick Rule with respect to the ability of a firm to reliably and quickly exit a position may result in major changes to the algorithms in use by the virtual market-making community.

6. We Urge the Commission to Consider the Impact of Imposing any Price Test-Based Restrictions on Short Selling in Combination with Guidance Recently Issued Regarding Marking of Short Sales[6]

a. Based on guidance provided in FAQ 2.5, orders placed in an attempt to close a long position will be negatively impacted by any price test rule, even though the intent of the order is not to effect a short sale

[5] Securities Exchange Act Release No. 34-60509, 74 FR at 42034
[6] Frequently Asked Questions ("FAQ") issued on August 28, 2009 by the Division of Trading and Markets

We applaud the SEC's issuance of the recent guidance on appropriate marking of orders in certain scenarios as described in FAQ 2.5. The "multiple orders in flight" scenario is one that is frequently encountered by Lime's client base.

As outlined in the FAQ, under a scenario where a seller is net long, but wants to simultaneously enter multiple orders that attempt to sell that long position, the guidance indicates that only one of those orders may be marked long; additional orders should be marked as "short". It is important to understand why this behavior occurs. A seller that wishes to exit a long position may see that there are multiple market centers disseminating best bids at the national "best" price. In an effort to ensure certainty of execution, they may send orders to two or more of these market centers. This will compensate for the fact that, due to latency, liquidity visible on a given market venue may not still be available by the time an order is sent to that market. In this type of strategy, the orders will be priced to "hit the bid" on the various market venues.

If the Alternative Uptick Rule were in place, in combination with this guidance, the seller would be unable to send orders to multiple market centers priced at the current national best bid. Only one order could be marked as a long sale and would therefore be allowably priced at the best bid price. The price-sensitive seller, instead of sending orders to multiple market centers simultaneously, would be forced into a serial approach of sending a long sale to a single market venue, waiting for a response, then if the order is not executed, moving on to the next market center – assuming that other market centers are still displaying the desired price. The likelihood of execution of that 1,000 shares would now be dramatically reduced. The Alternative Uptick Rule in this scenario imposes a significant barrier to execution ***on a seller with a net long position***. This cannot be in the best interest of the efficiency of the US Equity markets.

The impact of the other proposed price tests would have similar, although less severe, ramifications. Reducing the ability for that same long seller to access posted liquidity on market centers when that bid is not at a price considered an uptick (under either the Proposed Modified Uptick Rule or the Proposed Uptick Rule) would create similar inefficiencies and punish a net long seller in a similar manner as the Alternative Uptick Rule. We therefore believe that the Commission must take into account the effect of all proposed price tests on net long sellers who are employing strategies involving submitting multiple orders to exit their long position.

b. The Impact on Sellers with Net Long Positions Could be Mitigated with an Exemption for this Scenario

One potential mitigation strategy to avoid the unintentional impact of the Alternative Uptick Rule could be to allow an exemption for the type of activity described here. If a seller is marking orders as short due to the circumstances outlined in FAQ 2.5, their ability to exempt those orders from the price test rules that are designed to prevent undue downward pressure on a stock due to uncontrolled short selling, would eliminate this unintended negative consequence. Note we are not suggesting that the requirements to obtain locates in this scenario be relaxed.

CONCLUSION

In addition to our earlier comments on the proposal, Lime Brokerage has the following thoughts on the Alternative Uptick Rule as well as the proposal in general:

- **Additional Action is Required to Eliminate Naked Short Selling**
  - **Regulators must Visibly Enforce Regulation Regarding Naked Short Selling**
  - **Exemptions to Regulation SHO Should be Reviewed to Ensure they do not Provide Mechanisms to Undermine the Goal of Eliminating Naked Short Selling**
- **Price Tests Governing Trading in US Equities are Not the Most Effective Mechanism to Combat Short Selling in a Panic Scenario**
  - **The Proposed Circuit Breaker Halt Solution Will Provide the Market with a "Cooling Off" Period without the Negative Consequences of a Permanent, Market-Wide Restriction**
  - **Implementation of Price Tests Exclusively in the Equity Markets may Create Arbitrage Opportunities with Derivative Instruments**
  - **Price Tests that Regulate Trading in Downward Markets Display a Regulatory Bias towards Rising Markets**
- **The Proposed Alternative Uptick Rule Does not Address the Deficiencies of Price Tests and Would Introduce Significant Additional Barriers to Liquidity and Unintended Consequences**
  - **Variations in Infrastructure Quality and Sources of Data Will Lead to Inconsistent Views of the Current National Best Bid Across Market Participants**
  - **Allowing Short Selling to Occur Only on a Passive Basis will Have an Immediate and Unfavorable Impact on Market Liquidity and Pricing Efficiency**
  - **While Reducing Some Implementation Requirements, the Alternative Uptick Rule as Proposed does not Significantly Modify the Implementation Burden**
- **We Urge the Commission to Consider the Impact of Imposing any Price Test-Based Restrictions on Short Selling in Combination with Guidance Recently Issued Regarding Marking of Short Sales**
  - **Based on guidance provided in FAQ 2.5, orders placed in an attempt to close a long position will be negatively impacted by any price test rule, even though the intent of the order is not to effect a short sale**
  - **The Impact on Sellers with Net Long Positions Could be Mitigated with an Exemption for this Scenario**

The critical issues related to short selling currently facing the market and the Commission are both the elimination of naked short selling and the prevention of significant market disruption resulting from a panic situation. We believe that any regulatory action should be designed to achieve the goal of maintaining efficient markets in those conditions, rather than implementing a bias towards rising markets. We fear that shifting the focus and resources of the regulators and the industry towards implementation of an unnecessary and ineffective price test may distract us from the more important task of curbing what we believe is the more disruptive issue of continued naked short selling.

We applaud the Commission's thoughtful approach to implementing such significant legislation. We appreciate the continued solicitation of comments from industry participants as an integral part of the process of developing effective solutions to prevent abusive short selling and improve investor confidence in the US Equity markets.

Sincerely,

Jeffrey S. Wecker
CEO, Lime Brokerage LLC