EWT
LLC

September 21, 2009

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Release No. 34-60509, File No. S7-08-09, Amendments to Regulation SHO

Dear Ms. Murphy:

EWT, LLC ("EWT") appreciates the opportunity to provide the Securities and Exchange Commission (the "Commission") with comments on the proposed amendments[1] ("Proposed Amendments") and supplemental proposed amendments[2] ("Alternative Uptick Proposal") to Regulation SHO under the Securities Exchange Act of 1934 (the "Exchange Act").

I. **Overview**

EWT has strongly supported the Commission's efforts to restore investor confidence in U.S. financial markets, including appropriate measures to prevent abusive short selling. Given the restoration of investor confidence – demonstrated through numerous polls and the markets' incredible rebound of over 50% this year – we believe that substantial new restrictions on the natural purchase and sale dynamics of markets are surely not necessary.

However, should the Commission adopt short sale price restrictions, we urge that the Commission mitigate unintended consequences by narrowly targeting those restrictions to limit the potential impact of speculative or directional short selling in declining markets.

- The Commission should not adopt the Alternative Uptick Proposal, which would impair all manner of legitimate activity in all market conditions, whether advancing or declining.

- The Commission should include suitable protections for non-speculative activities that benefit the market, such as market making, trading in broad based index products, and economically neutral trades executed in multiple forms and marketplaces.

Without these protections, over-broad short sale restrictions would, in our view, result in impaired price discovery, wider bid-offer spreads (at a greater cost to investors), less overall liquidity, and an increase in the flight of liquidity from the public markets – a series of consequences that will severely undermine investor confidence.

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1 Release No. 34-59748, 74 Fed. Reg. 18042 (Apr. 20, 2009) (the "Proposing Release").

2 Release No. 34-60509, 74 Fed. Reg. 42033 (Aug. 20, 2009) (the "Supplemental Release", and together with the Proposing Release, the "Releases").

II. Background

EWT is a proprietary, self-clearing broker-dealer registered with the Commission under Section 15 of the Exchange Act. EWT is a member of the Financial Industry Regulatory Authority, the New York Stock Exchange, NASDAQ and, together with its affiliates, operates across more than 25 other exchanges and market centers around the world. Engaging in direction-neutral algorithmic trading and using proprietary trade execution technology, EWT has a significant market share in several asset classes and is an active participant in the public equities markets. EWT does not engage in customer transactions and derives its income from its proprietary market making activities. As a market maker, EWT provides significant liquidity to the marketplace and investors. It does not seek to profit from "bets" on downward market movements, through short sales or otherwise.

As an active participant in the equities market, EWT strongly supports the efforts of the Commission to maintain and promote fair and orderly markets through carefully considered rule-making. The Commission's decision to seek additional comment on the significant changes contemplated by the proposed short sale restrictions demonstrates a commitment to a thoughtful and deliberative process, and affords both the Commission and market participants the opportunity to carefully consider these issues without the pressure and emotion that characterized the financial crisis of the past year. While our previous comment letter on the Proposed Amendments focused on technical aspects of proposed rules, we believe that at this time it is appropriate to evaluate the broader context and implications of the proposed rules.[3]

III. Investor Confidence

Between July 2007 and March 2009 the Dow Jones Industrial Average lost approximately 50% of its value and the Standard & Poor's 500 Index lost approximately 54% of its value.[4] As the market hit bottom in March, the psychological state of investors was of prominent concern, and was often presented to the Commission as a rationale for implementing new short sale restrictions. The Commission responded to these requests promptly and appropriately, seeking public comment on the possibility of new short sale restrictions and whether or not such restrictions would bolster investor confidence and promote market efficiency and integrity, with the release of the initial Proposed Amendments on April 10, 2009.

It is important to note that the Commission's actions to support investor confidence began long before the release of the Proposed Amendments, and we believe that the

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3 See Letter from Peter Kovac, Chief Operating Officer and Financial and Operational Principal, EWT, to Elisabeth M. Murphy, Secretary, the Commission, dated June 19, 2009 (the "June 19 Letter"). For convenience, we have attached a copy of the June 19 Letter as Appendix C.

4 Proposing Release at 18048.

seeds planted by these initiatives almost a year ago have begun to bear fruit in the past few months. Specifically, rulemaking targeting the spreading of false rumors, abusive "naked" short selling,[5] and other manipulative conduct, coupled with increased reporting obligations, increased resources for enforcement, and the recent enforcement actions this has enabled, have demonstrated to the public the Commission's strong commitment to market integrity. Concurrent initiatives to address equities settlement and failures to deliver have also had significant impact and have proven successful at meeting their stated goals.[6] In sum, the Commission has established the appropriate regulatory framework to police abusive short selling, allocated the requisite resources, and demonstrated effective and rigorous enforcement, providing investors with the confidence that manipulative conduct will not be tolerated.

At the same time, the underlying causes of the financial crisis have come to be better understood and, in some part, addressed. Correspondingly, empirical evidence from numerous sources indicates that investor confidence has improved as much as 40% since the start of 2009, and by some measures is now the strongest it has been in years.[7] The market itself has seen a stunning and unprecedented recovery of approximately 50% in less than six months,[8] a phenomenon which is both indicative of and dependent upon strong investor confidence. By any

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5 An "abusive 'naked' short sale" is not defined in Regulation SHO, but we understand it to be a short sale made without having stock available for delivery (or locating such stock) and then intentionally failing to deliver stock within the standard three-day settlement cycle. The Commission has previously provided guidance in this regard in Release No. 34-56212 (Aug. 7, 2007), 72 Fed. Reg. 45544 (Aug. 14, 2007), and Release No. 34-54154 (July 14, 2006), 71 Fed. Reg. 41710 (July 21, 2006).

6 We note that technical details of Rule 204 (formerly, temporary Rule 204T) have resulted in unintended adverse consequences including a significant and troubling reduction in credit available to broker-dealers, and substantially increased market volatility around the open and close of trading. See Letter from Peter Kovac, Chief Operating Officer and Financial and Operations Officer, EWT, to Florence Harmon, Acting Secretary, SEC, dated November 25, 2008.

7 The State Street Investor Confidence Index for August 2009 was 122.9, 36.0 points above its January 2009 low of 86.9. The index was last above 122.9 in May 2004. *See* State Street, Investor Condidence Historical Data, *available at* http://www.statestreet.com/industry_insights/investor_confidence_index/historicaldata.pdf. The Bloomberg Professional Global Considence Index set two consecutive record highs in August and September 2009. *See* Shamim Adam , "Global Confidence Is at Record High as Slum Eases" (Sept. 17, 2009), *available at* http://bloomberg.com/apps/news?pid=20601103&sid=afr2BGtcLHEY. The Gallup Index of Investor Optimism has increased by 73 points from its low in February 2009 through August 2009 (), and the Rasmussen Investor Index has increased over 60% from its March 9, 2009, record low of 54.7 to a level of 91.8 on September 21, 2009. *See* Dennis Jacobe, "U.S. Investor Optimism Rises to Higest Level of the Year", Aug. 28, 2009, *available at* http://www.gallup.com/poll/122585/investor-optimism-rises-highest-level-year.aspx?version=print and Rasmussen, "Consumer & Investor Indexes Hold Relatively Steady on Monday", Sept. 21, 2009, *available at* http://www.rasmussenreports.com/public _content/business/indexes/rasmussen_consumer_index2/rasmussen_consumer_index. Additionally, during Treasury Secretary Geithner's testimony before Congress on September 10, 2009, he emphasized that "investors are gaining confidence in the market". Testimony of Timothy F. Geithner, Secretary of the Treasury, before the Congressional Oversight Panel (Sept. 10, 2009).

8 Since its low on March 9, 2009, the Dow Jones Industrial Average has recovered 3,273.15 points to close at 9,820.20 on September 18, 2009.

measure, then, it appears that investor confidence has been restored, independent of the implementation of any short sale price restrictions.

We recognize that investor confidence was of serious concern in early 2009 and a significant factor behind calls for the Commission to implement new short sale restrictions. Even if it was appropriate at that time to consider investor psychology through the rulemaking process, the clear evidence today demonstrates that investor confidence has largely recovered. Rather than investor psychology, investor protection should be foundation and motivation for any additional market restrictions. Any additional restrictions should be grounded in sound economic analysis and vigorous enforcement. Accordingly, should any restrictions be adopted, we strongly recommend that they be adopted in the context of a pilot program so the impacts can be carefully studied.

IV. Substantial New Short Sale Restrictions Are Unwarranted

The most recent data available today supports the same important conclusions that led the Commission to remove short sale price restrictions in July 2007: first, that long selling, much more significantly than short selling, contributes to downward price pressure in the market, and therefore short sale restrictions do not prevent downward market movements; and, second, restrictions on short sales impair liquidity, widen bid/offer spreads, and result in significantly increased costs to investors.[9]

Today, as in 2007, there is no compelling evidence that short sale restrictions can curb large downward price movements in the market. The Office of Economic Analysis's review of the September 2008 short sale ban supported prior research that long sales are the primary drivers of downward price movements, noting that, "In general, during periods of extreme negative returns, the sell pressure is more intense for long trades indicating that short sales put less pressure on prices than other sales during periods of extreme negative returns."[10] Other recent analysis supports this notion, noting that the wholesale prohibition of short sales in September 2008 did not prevent the targeted stocks from declining more than 20% during that brief period, and that most downward price movement is caused by long sales, not short sales.[11]

Moreover, the evidence available suggests that substantial unintended consequences result from short sale restrictions, including decreased liquidity and increased bid/offer spreads. While much of this evidence has already been analyzed in depth in previous

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9 For our discussion of the July 2007 rulemaking process, see footnote 3 of the June 19 Letter and the accompanying text.

10 Office of Economic Analysis Memorandum "Re: Analysis of Short Selling Activity during the First Weeks of September 2008", December 16, 2008, at 2. Further, the study's additional finding that the volume of short sales as a fraction of market volume is higher in upward trending markets than in downward trending markets suggests that short sales may dampen market volatility. Id. at 1.

11 *See* Credit Suisse Portfolio Strategy, AES Analysis (Apr. 23, 2009) at 7.

comment letters on these proposals, and the Releases themselves, which describe this very phenomenon, we note that the impact of this is far from trivial: the observed increase in bid/offer spreads of 18.48 basis points attributable to the September 2008 ban would today cost investors over a quarter *billion* dollars a day.[12] The consensus of recent studies is perhaps best summed up in the Kolasinski, Reed, and Thornock study cited by the Commission in the Rule 204 Adopting Release,[13] which, after statistically demonstrating the "significant reductions in market quality" resulting from the July 2008 emergency order and September 2008 short sale ban, concludes that "for many stocks subject to the rule changes, the rule changes were effectively increases in costly short sale constraints that have the expected, negative, effects on markets."[14]

Based on the ample evidence that (1) coincident with numerous Commission initiatives, investor confidence has dramatically increased in the past six months, (2) short sale price restrictions have at best dubious utility in preventing downward price declines, and (3) short sale price restrictions have well-documented and substantial deleterious effects on the markets, we encourage the Commission to conclude that new short sale price restrictions should not be implemented at this time.

V. The Alternative Uptick Proposal Is Unduly Restrictive

Of the five approaches set forth between the Proposed Amendments and the Alternative Uptick Proposal, the Alternative Uptick Proposal is the most draconian measure and therefore magnifies the problems outlined above – a point clearly illustrated in the Supplemental Release itself, which notes that "because the alternative uptick rule would restrict short selling to a greater extent than either the proposed modified uptick rule or the proposed uptick rule, it could also potentially lessen some of the benefits of legitimate short selling, including market liquidity and pricing efficiency to a greater extent. Thus, there may be potential costs associated with the alternative uptick rule in terms of potential impact of such a price test on quote depths,

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12 See Credit Suisse Portfolio Strategy, AES Analysis (November 12, 2008). The Credit Suisse study demonstrates an increase of 18.48bp in bid/offer spreads attributable to the September ban. Average daily notional volume in the US equity markets is currently $208.1 billion. See BATS Exchange Market Volume Summary, August 20 to September 17, 2009. An additional 18.48 basis points of cost is therefore $384 million per day, pure "dead weight loss" to investors and the markets. For convenience, we attach a graphical illustration of the Credit Suisse regression analysis as Appendix B.

13 Release No. 34-60338, 74 Fed. Reg. 38266 (July 31, 2009), at 38286.

14 Adam C. Kolasinski, Adam V. Reed, and Jacob R. Thornock, Prohibitions versus Constraints: The 2008 Short Sales Regulations, March 2009 working paper at 28. The report abstract summarizes it thusly: "Consistent with the model, we find that both the [July 2008] emergency order and the [September 2008] ban resulted in significant reductions in market quality. Further, we find that the ban decreased liquidity and increased the informativeness of short sales, and that both these changes were especially strong for stocks with listed options" Id. at 1. The analysis also finds that "The ban on short sales likely increased illiquidity for all affected stocks since it eliminated a whole host of liquidity traders from the market." Id. at 20-21. Other studies this year, such as Boehmer, Ekkehart and Wu, Short Selling and the Informational Efficiency of Prices (Jan. 8, 2009), have also demonstrated the beneficial impact of short selling on efficient price discovery and reducing volatility.

spread widths, market liquidity, execution and pricing inefficiencies."[15] In contrast to the other approaches outlined previously, which affected all trades in a declining market and indirectly affected hedging and market making activity in both declining and advancing markets, the Alternative Uptick Proposal would affect all trades in both advancing and declining markets.[16]

This indiscriminate application of the restrictions effectively undermines and severely impairs the role of short selling in price discovery, and significantly increases the costs of market making and hedging activities by restricting the ability of market participants to immediately hedge their exposure. By removing this ability to immediately hedge and thus interfering with a market maker's ability to maintain narrow spreads and deep liquidity, this proposal artificially introduces a significantly hazardous element of risk into the markets, contrary to the goals of preserving investor confidence and market integrity.

Weighed against the significant costs of this extraordinarily broad proposal is the speculative benefit that exchanges and dark pool operators may implement this system more easily, and thus at a lower cost. We emphasize, however, that this proposal will still impose significant implementation costs on thousands of broker-dealers across the broader financial services industry. In this regard, we note that we estimate that it would take at least 20 weeks for a fully-staffed, highly-skilled and knowledgeable IT department to implement the Alternative Uptick Proposal.[17] In contrast, the main difference in implementation among the proposals is that the modified uptick rule and proposed uptick rule refer to a prior price and therefore require an additional "state" to be maintained in the software – approximately 4 bytes per security, a trivial amount. In sum, the net savings of the Alternative Uptick Proposal to the broader industry compared to other proposals would at best be minimal, and potentially could be large and negative, as the burden of implementation costs is pushed onto the shoulders of thousands of broker-dealers.[18]

Regardless, we do not believe that permanent market structure should be determined by the impact on the budgets of a handful of exchanges and bulge bracket dark pool operators,[19] but rather that the inquiry should be on its likely impact on the market as a whole, and ultimately how it affects the investing public. Likewise, we are unaware of any empirical

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15 Supplemental Release at 42034

16 Id. We also note that, as we explained in the June 19 Letter, "advancing" and "declining" is somewhat of a misnomer as markets do not move uniformly in a single direction – a generally advancing market sees many minute declines in many issues despite the general upward trend. June 19 Letter at 6-7.

17 As a result, in our view, the estimate for implementation costs included in the cost-benefit analysis section of the Proposing Release may significantly underestimate the true costs facing many broker-dealers. See Proposing Release at 18092-95.

18 We note that the Proposing Release estimated ongoing costs to broker-dealers to be ten times greater than those to trading centers for the modified uptick rule, totaling over half a billion dollars annually. See Id.

19 See Supplemental Release at 42034.

evidence demonstrating the benefits of the Alternative Uptick Proposal, or any of the other short sale restrictions proposed. In fact, the only empirical evidence relating to this issue of which we are aware demonstrates that short sale restrictions would have significant costs to the markets as a whole, and ultimately a cost to individual investors of millions of dollars a day.[20] Viewed in this light, the costs to the markets and the public from the alternative uptick rule far outweigh any benefits, both on an absolute scale and when compared to the other approaches previously proposed.

We respond to the Supplemental Release's requests for comment on specific issues in Appendix A.

VI. Market Makers and Market Integrity Must Be Protected

In the June 19 Letter, we reviewed the beneficial role of market makers in support of the financial markets, noting that the role of market makers is, in fact, to ensure that there *are* financial markets by creating a two-sided market for securities, enabling investors to buy or sell at a fair price.[21] This activity in turn facilitates price discovery, dampens volatility, counteracts market manipulation, and harmonizes pricing across disparate markets. Each of these activities is beneficial to the market in normal conditions, but becomes crucial in a crisis, as fair and transparent markets and accessible prices are important conditions precedent to faith in the markets.

It is important to note that the service that market makers provide is distinct from other investment and trading activity in that a market maker does not seek to profit from speculation that a security will increase or decrease in value. In the rule-making process, it should be recognized that there is an important distinction between speculative activity regarding an individual security, and non-speculative activities such as bona fide market making. This fundamental distinction has been implicit in the discussion to date, and no serious commenter has claimed that market making and risk mitigating hedging activities have anything but a dampening effect on market volatility. Nevertheless, it bears repeating that market making has a significant beneficial impact, and it ought to be made explicit that this activity should not be discouraged through unnecessary and adverse regulation that is aimed at an entirely different category of activities.

For these reasons, and those discussed in more detail in the June 19 Letter, any short sale price restrictions that are implemented must have an appropriate exemption for bona fide market making.[22] This becomes even more critical when considering a sweeping proposal such as the Alternative Uptick Proposal, which could effectively prohibit market making for all but a select few firms.

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20 See note 12.

21 June 19 Letter at 3.

22 See Id. at 3-8.

Also as noted in the June 19 Letter, any short sale restrictions should as well include appropriate exemptions to protect trading in broad-based index products and risk-mitigating hedging activities, both of which are fundamental to market integrity and stability.[23] Doing so will significantly reduce the unintended consequences that would result otherwise, including increased transaction costs for investors, decreased liquidity, impaired price discovery and the movement of liquidity away from the public markets to dark pools where abusive activity cannot be as effectively policed.

VII. Recommendations

In light of the concerns described above, we urge the Commission to review fully the implications of the Proposed Amendments and Alternative Uptick Proposal and evaluate whether or not new short sale price restrictions are warranted, especially in light of the success of numerous other Commission initiatives in preventing short selling abuses, the visible restoration of investor confidence and market rebound, and the demonstrable unintended consequences resulting from any such restrictions (not to mention the unforeseen unintended consequences that would assuredly also result).

Should the Commission decide to adopt a short sale price restriction, such an approach should meet the stated goals of limiting the potential impact of speculative or directional short selling in declining markets, while concurrently maintaining the fair and orderly markets upon which investor confidence ultimately relies. In particular, EWT believes that any such approach should be narrowly tailored such that any restrictions avoid adversely affecting non-directional activities such as market making and risk mitigating hedging. The Alternative Uptick Proposal cannot be narrowly tailored due to its design: it is intended to be "always on," restricting activity in advancing and declining markets, every second of the day, regardless of whether or not such activity is speculative, liquidity providing or risk-mitigating. Among the other proposals, the modified uptick rule based on current bid data appears to impose the fewest unintended costs on market integrity and efficiency.[24] However, more significant than the selection of any particular approach for market integrity is the proper tailoring of any restrictions to avoid curtailing beneficial market activity.

Therefore, as in the June 19 Letter, we respectfully request that the Commission consider, in particular, each of the modifications we suggest below, which we believe preserve

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23 Id. at 9.

24 Although we believe that each of the proposed implementation mechanisms have certain disadvantages, we believe that the approach with the fewest adverse consequences for the market would be the proposed modified uptick rule based on current bid data. The uptick rule based on last sale data is unworkable in today's decentralized markets, and the circuit-breaker approaches may exacerbate market dislocations by suddenly and unexpectedly altering the regulatory regime and liquidity characteristics of a particular security, precisely when it is under duress. Regardless, the myriad of permutations makes succinct analysis difficult, and we hope there will be additional opportunity to comment once a single approach is selected but prior to adoption.

the central objectives advanced by the Commission and which we have ranked in order of importance:

(1) The Commission should implement an exemption from any short sale price restrictions for bona fide market making activity. This targeted exemption would permit market makers to continue to provide competitively priced liquidity, ensuring functioning markets, the cornerstone of investor confidence.

(2) The Commission should implement an exemption from any short sale price restrictions for activity that results in no net short economic exposure for a particular issuer (e.g. an equities position hedged with equivalent futures, an ETF position hedged with the components of the ETF, a depository receipt hedged with the underlying security). This would permit a very narrow range of risk mitigating trades while protecting the issuer from any true directional pressure. Risk-mitigating hedging is a key stabilizer in turbulent markets, and restricting the ability to reduce one's risk would be a serious blow to investor confidence. We note that both the United Kingdom's Financial Services Authority and the Netherlands' Authority for the Financial Markets adopted this approach in their recent short selling restrictions as well.

(3) The Commission should implement an exemption for securities based on broadly-defined indexes, such as ETFs and closed-end funds. By definition, these instruments do not reflect upon a single issuer; moreover, they are frequently used in risk mitigation as a hedge for unwanted risk. As mentioned above, the ability to reduce one's risk is a critical component of investor confidence.

(4) The Commission should implement the proposed "broker dealer provision" as defined in the Proposed Modified Uptick Rule (201(c)), which permits the broker dealer to verify compliance with the bid test on order submission. Without this exemption, an exchange receiving lagged or stale market data from another exchange may incorrectly refuse to execute a directed order, creating directly contradictory requirements between Regulation NMS (which requires routing the order to the exchange) and Regulation SHO (which requires the exchange to reject the order) for the broker dealer.

Finally, we hope that any implementation of the Proposed Amendments will include a pilot test similar to the test employed in 2004, so that an accurate measurement of the costs and benefits of these actions may be taken. In addition, we urge the Commission to publish the text of any proposed rule so that market participants may provide appropriate feedback. We note it has been difficult to provide comments on a "moving target" since multiple variations have been proposed, many in concept form, and we are unsure what combination of restrictions will feature in a final rule.

More generally, as market sentiment eases, we urge the Commission to maintain its broad perspective in evaluating Regulation SHO, and to continue its extensive monitoring of short sales and other market data. The evolution of Regulation SHO over the past several years has generally reflected the Commission's balanced and thoughtful approach to the complex issues raised by short sales. We believe that careful refinement and targeting of its provisions, rather than sweeping market restrictions that risk substantial unintended consequences, offers the greatest protection for improved future market stability.

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EWT appreciates the opportunity to comment on the Proposed Amendments and would be pleased to discuss any of the comments or recommendations in this letter with the Commission staff in more detail. If you have any questions, please do not hesitate to contact the undersigned at (310) 651-9746.

Sincerely,

Peter Kovac
Chief Operating Officer and
Financial and Operations Principal

cc: Mary L. Schapiro, Chairman
Kathleen L. Casey, Commissioner
Elisse B. Walter, Commissioner
Luis A. Aguilar, Commissioner
Troy A. Paredes, Commissioner

James A. Brigagliano, Co-Acting Director
Daniel M. Gallagher, Co-Acting Director
Josephine J. Tao, Assistant Director
Victoria L. Crane, Branch Chief
Division of Trading and Markets

Appendix A: Response to Comment Requests

The Supplemental Release solicits comments on specific issues. In response, we offer our observations on the comment requests below, for issues not already addressed in this comment letter or the June 19 Letter:

A. Responses to Renewal of Comment Requests

1. *Would the alternative uptick rule be more effective at preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to drive down the market or from being used to accelerate a declining market than the approach set forth in the proposed modified uptick rule or proposed uptick rule? If so, how? If not, why not?*

We believe that ultimately neither approach will be able to prevent abusive short selling from being used as a tool to drive down the market. In fact, the impairment of market-making activity and other liquidity-providing activity resulting from the proposed restrictions may make it easier for speculators to engage in manipulative activity, as the would-be manipulator faces less natural counter-balance in the markets. Vigorous enforcement of prohibitions against illegal trading activity and market manipulation is by far the strongest deterrent to illegal activity, is more flexible and better targeted toward discouraging such activities, and has the added benefit of not imposing significant restrictions on legitimate and beneficial activity.

2. *What effect would the alternative uptick rule have on the benefits of short selling, such as providing price efficiency and liquidity?*

As discussed above, the Alternative Uptick Proposal will impair both price discovery and liquidity, increasing costs to investors and accelerating the movement of liquidity away from the public markets to dark pools. Moreover, as noted in the Supplemental Release, this impairment will be even more severe than under the other proposals and thus the unintended consequences are magnified with the alternative uptick proposal.

3. *Would the alternative uptick rule be easier to program into trading and surveillance systems than the approach in the proposed modified uptick rule or proposed uptick rule? If so, why? If not, why not?*

As discussed above, the Alternative Uptick Proposal may be easier for exchanges and some large firms to implement, but not necessarily for the broader community of broker-dealers, who will have to significantly modify their trading platforms to enforce the new restrictions, implement additional compliance systems and procedures, and make material changes to legitimate market-making strategies to conform to the new restrictions. As a general matter, broker-dealer costs far outweigh trading center costs – for example, the Proposing Release estimates the initial compliance costs and ongoing annual compliance costs for broker-dealers to be more than ten times higher than the initial compliance costs for trading centers.[25] As discussed in our response to question 10, the overall implementation requirements for the Alternative Uptick Proposal are substantially similar to those of the other proposals. Moreover, regardless of what proposal is implemented at the trading centers, broker dealers still must modify their order management systems, compliance systems, and customer and proprietary trading systems to accommodate any rule change.

Far greater than the cost to professionals in reprogramming their trading systems, however, will be the burden of higher trading costs levied on investors by implementing the most restrictive option. While the Proposing Release estimates ongoing compliance costs to be more than $600MM on an annual basis, these costs pale in comparison to the potential impact to market efficiency. If the restrictions resulted in a widening of bid/offer spreads by just a third of a basis point – the September 2008 ban resulted in a fifty times greater widening of bid/offer spreads – the annual cost would be over $1 billion, far more than the ongoing implementation costs.

4. *If adopted, should the alternative uptick rule be combined with a policies and procedures approach similar to that discussed under the proposed modified uptick rule or a prohibition approach similar to that discussed under the proposed uptick rule? What would be the advantages and disadvantages, including costs and benefits of each of these approaches as combined with the alternative uptick rule?*

A policies and procedures approach is the most viable option for any restrictions of this scope and complexity, with exchanges supporting this through a prohibition approach for non-exempt orders. By way of example, all of the contemplated restrictions are quite similar from an implementation perspective to Regulation NMS, which also requires cognizance of current market data, connectivity to multiple market centers, and awareness of and compliance with relevant exemptions. Regulation NMS is well served by the policies and procedures approach at the broker-dealer level and a prohibition approach at the exchange level, and any contemplated short sale restrictions would also be best implemented with this model.

5. *If the Commission were to adopt a circuit breaker rule, should the circuit breaker, when triggered, result in the alternative uptick rule? If so, why? If not, why not?*

While we do not recommend adopting any short sale price restrictions, if the Commission were to adopt the Alternative Uptick Proposal, we would especially recommend against the circuit breaker approach. Any particular security that has fallen to "circuit breaker

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[25] <u>See</u> Proposing Release at 18092-94.

levels" will be further disadvantaged if there is an additional abrupt change in its liquidity. As discussed above, the short sale price restrictions will inhibit normal-course liquidity provision in the markets, and thus the security in question will not only suffer a decline of 10% or more, but will also suddenly face decreased liquidity – a scenario which could very likely exacerbate, if not spark additional downward momentum.

B. Responses to Supplemental Comment Request

1. *How effective would the alternative uptick rule be at helping to prevent short selling, including potentially abusive or manipulative short selling, from being used as a tool for driving the market down or from being used to accelerate a declining market by exhausting all remaining bids at one price level? Please explain and provide empirical data in support of any arguments and/or analyses. Could the alternative uptick rule be modified to better meet these goals? If so, how? Please explain and provide empirical data in support of any arguments and/or analyses.*

We believe that ultimately neither approach will be helpful in preventing abusive short selling from being used as a tool to drive down the market. The overwhelming evidence is that the dramatic price declines seen in 2008 were primarily due to long sellers, an activity which is not affected by the proposed restrictions. Additionally, the blanket application of the Alternative Uptick Proposal to all types of securities (including ETFs and other securities not tied to a single company) and various types of non-speculative activity (e.g. market making and risk-mitigating hedging activities) would not, in our view, improve from the effectiveness of the proposed rule in protecting individual issuers. Moreover, the impairment of market-making activity and other liquidity-providing activity resulting from the proposed restrictions may make it easier to engage in manipulative activity, as the would-be manipulator faces less natural counter-balance in the markets. As we noted in our response to renewed comment 1, vigorous enforcement of existing prohibitions against illegal trading activity and market manipulation is by far the strongest deterrent to such activities, is more flexible and better targeted toward discouraging such activities, and has the added benefit of not imposing significant restrictions on legitimate and beneficial activity.

2. *How would the alternative uptick rule affect short selling in an advancing market? How would the alternative uptick rule affect short selling in a declining market? Please explain and provide empirical data in support of any arguments and/or analyses.*

Although the market is never uniformly advancing nor declining, in the case of the Alternative Uptick Proposal, the issue is moot: as noted in the Supplemental Release, the Alternative Uptick Proposal restricts short selling regardless of whether it is an advancing or a declining market. Market making and risk-mitigating hedging activities are thus impaired at all times, and, presumably, the beneficial role of short selling in curbing excessive and manipulative upward speculation (e.g. "pump and dump" schemes) would be severely curtailed, to the detriment of the markets.

3. *To the extent that there are concerns regarding investor confidence based on the numerous requests for reinstatement of short sale price test restrictions, would adopting the alternative uptick rule help restore investor confidence? If so, why? If not, why not? Please explain and provide empirical data or other specific information in support of any arguments and/or analyses.*

While the volume of requests received by the Commission is indeed numerous, the vast majority of requests for imposition of new short sale price test restrictions are in fact variations of a form letter sent at the behest of a popular television personality and systematically generated through his website. At most, this biased sample reflects these viewers' broader concerns and frustrations regarding the dramatic, although ultimately short-lived, decline in value of their savings and retirement assets, and perhaps their general concerns regarding our nation's economic recovery. Notably absent is any thoughtful evaluation of the market impact of reinstating short sale price test restrictions or the nexus between this proposed action and the effects it is supposed to encourage.

Moreover, it is unfortunately the case that the public seldom writes to express their appreciation for good policy and governance – despite the fact that, in this case, the U.S. equity markets functioned extraordinarily well in the financial crisis, while numerous other markets sputtered or seized up completely – and therefore it is impossible to judge overall confidence or sentiment based solely on volume of responses or the number of consecutive capital letters used.[26] As mentioned above, recent polls indicate actual investor confidence has been restored, and the market itself reflects this sentiment.[27] We view this as evidence that the Commission's recent work to increase investor *protection*, coupled with improving overall market conditions, naturally have improved investor confidence.

4. *In addition to investor confidence and market volatility, we have stated that we are concerned about potentially abusive short selling. Would the alternative uptick rule help address potentially abusive short selling? If so, how? If not, why not? Please explain and provide empirical data in support of any arguments and/or analyses.*

5. *In the Proposal, we also noted that short selling may be used to illegally manipulate stock prices. What impact, if any, would the alternative uptick rule have on short selling*

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[26] A sampling of comment letters received indicates that those whose authors are familiar with the markets, either through practice or academic study, concur with the conclusions of the 2003-2007 studies that short sale price restrictions are unnecessary and may prove detrimental to market efficiency.

[27] See note 7.

used to illegally manipulate stock prices? Please explain and provide empirical data in support of any arguments and/or analyses.

6. *What impact, if any, would the alternative uptick rule have on "bear raids"? Please explain and provide empirical data in support of any arguments and/or analyses.*

The Alternative Uptick Proposal, as well as the other variations proposed, would each serve to restrict short selling, legitimate and otherwise. However, we note that for many of the published enforcement actions regarding short selling abuses, the perpetrators appeared to conceal their manipulative actions through other fraudulent misrepresentations (e.g. marking short sales as long sales, altering ticket information, etc.) and therefore their activity would not have been prevented by short sale price restrictions.[28] In each case, it is clear that the best deterrent for such fraudulent activity is rigorous and vigorous enforcement.

7. *Would the alternative uptick rule be an appropriate short sale price test in the current decimals environment? Would the alternative uptick rule be more suitable than the proposed modified uptick rule or the proposed uptick rule in a decimals environment with multiple trading centers? Please explain and provide empirical data in support of any arguments and/or analyses.*

As we have stated previously, we do not believe the proposed uptick rule to be a viable option in the current decimals environment with multiple trading centers. Both the Alternative Uptick Proposal and the proposed modified uptick rule are more suitable to current market structure, but both approaches will suffer from the data latency and race conditions that result from any distributed system, which will result in inconsistent application of the rule at any given point in time across multiple market centers.

8. *How would trading systems and strategies used in today's marketplace be affected by the alternative uptick rule? How might market participants alter their trading systems and strategies in response to the alternative uptick rule, if adopted?*

As we explained in the June 19 Letter, by restricting short sales executed by market makers in the course of their market making, market makers are less able to hedge their risk.[29] The natural consequence is that they widen their quotes to compensate for the additional risk, thus reversing the market's historical trend toward tighter markets, and thereby increasing the costs for individual investors. Furthermore, market makers and other market participants will need to expend considerable resources to implement the necessary trading safeguards,

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28 We are not aware of any evidence presented regarding "bear raids" in modern markets and therefore cannot comment on the efficacy of any proposed rules in this regard.

29 June 19 Letter at 7.

compliance systems, and modifications to trading strategy systems to incorporate the new restrictions. Again, the cost of these modifications is likely to be reflected in higher bid-offer spreads, which will ultimately be costs borne by individual and institutional investors.

9. *What impact, if any, would the trading requirements of Regulation NMS have on implementing the alternative uptick rule?*

For the alternative uptick proposal to be viable in a Regulation NMS environment, it will need to have the "broker-dealer" exemption contemplated for the modified uptick rule. For example, if a market center is disseminating invalid quotations and other market centers have declared "self help" on that market center, a broker dealer's short sale orders should not be rejected if they appear to cross the invalid market data.

10. *The proposed modified uptick rule and the proposed uptick rule have as their reference point for a permissible short sale the current national best bid, and the last sale price, respectively, in relation to the last differently priced national best bid, and the last differently priced sale price, respectively. In contrast, the alternative uptick rule would have as its reference point the current national best bid. Accordingly, the sequence of bids would not play a role in determining when short sales are permissible. How would removing bid or sale price sequencing from the requirements of a short sale price test restriction, if adopted, affect implementation costs, ongoing costs, the effectiveness of the restriction in achieving the Commission's goals, market liquidity, pricing efficiency, and investor confidence?*

The maintenance of a valid and correct national best bid is dependent upon the proper in-order handling of market data updates, and thus <u>all</u> implementations rely on a sequence of bid data. The main difference in implementation among the proposals is that that the modified uptick rule and proposed uptick rule refer to a prior price and therefore require an additional "state" to be maintained in the software – approximately 4 bytes per security, a trivial amount. The majority of the implementation arise from implementing the restrictions in general and, for broker-dealers, for also implementing the logic to handle the rejections they will receive from the exchanges when placing orders to sell short, and developing the systems to handle these scenarios on behalf of customer orders.

11. *If we were to adopt the alternative uptick rule, would a two month implementation period following the effective date of the alternative uptick rule be appropriate? Would a shorter or longer implementation period be more appropriate for the alternative uptick rule? Please explain.*

12. *Because the alternative uptick rule would not require monitoring of the sequence of bids or last sale prices (i.e., whether the current national best bid or last sale price is above or below the previous national best bid or last sale price), could this type of rule be implemented more quickly than the proposed modified uptick rule or the proposed uptick rule?*

Based on our experience a two month implementation period would be an extremely aggressive schedule. Although it is difficult to estimate comprehensive implementation costs without additional specifics on the proposed restrictions, we estimate aggressive development times for a fully-staffed, highly-skilled and knowledgeable IT department as follows:

Task	**Timeframe**
Implementation of logic into order management system	4 weeks
Adaptation of market making systems and/or customer trading interfaces	4 weeks
Implementation of compliance data capture and retention systems	4 weeks
Implementation of compliance reports	4 weeks
Integration testing	4 weeks
Total	**20 weeks**

While we have estimated a five month implementation schedule, we note that other estimates provided for these proposals and technically similar projects range from six months to one year.[30] Regulation NMS, which in many technical aspects is a similar project that combines consolidating of quote data with the application of a set of market-data-based order restrictions, had a considerably longer timeframe for implementation, and was delayed repeatedly as market participants severely underestimated the time required for a full implementation. Provided that broker-dealers' implementations of Regulation NMS was sufficiently modular and extensible, such prior work may be leveraged to achieve the aggressive implementation schedule outlined above. If this proves not to be the case, the timeframe would need to be significantly extended.

[30] Proposing Release at 18094-95.

13. *What would be the impact of the alternative uptick rule on off-exchange trading? Specifically, would there be any special concerns with respect to off-exchange trading in connection with the alternative uptick rule, such as systems and/or implementation issues, or additional or alternative provisions that should be considered?*

As discussed in the June 19 Letter, any restrictions that impair the ability of market makers to function, such as the proposed rules, will result in wider bid-offer spreads.[31] The widening of bid-offer spreads permits more volume to be routed to dark pools and internalization engines and increases off-exchange activity.

14. *As discussed above, if adopted with a policies and procedures approach, similar to the proposed modified uptick rule, the following short sale orders could be marked as "short exempt" and could, therefore, be exempt from the requirements of the alternative uptick rule: (i) a seller's delay in delivery as set forth in Section III.A.2.b of the Proposal; (ii) odd lots, as set forth in Section III.A.2.c. of the Proposal; (iii) domestic arbitrage, as set forth in Section III.A.2.d. of the Proposal; (iv) international arbitrage, as set forth in Section III.A.2.e. of the Proposal; (v) over-allotments and lay-off sales, as set forth in Section III.A.2.f. of the Proposal; (vi) transactions on a VWAP basis, as set forth in Section III. A.2.h. of the Proposal; and (vii) riskless principal transactions as set forth in Section III.A.2.g. of the Proposal. In addition, if adopted with a prohibition approach, the exception specific to the proposed uptick rule for error in marking a short sale, as set forth in Section III.B.2.a. of the Proposal, would also apply to the alternative uptick rule. Are these "short exempt" provisions or exceptions necessary or appropriate? If so, why? If not, why not?*

15. *Are there other "short exempt" provisions or exceptions that should apply to the alternative uptick rule? If so, please explain. Should a general market maker exception apply to the alternative uptick rule? Should an options market maker exception apply? What should be the scope of any such exceptions? Should additional conditions apply to a market maker exception under the alternative uptick rule to ensure that only bona fide market making is captured by the exception?*

As discussed in the June 19 Letter, we believe that any restrictions should include additional exemptions for bona fide market making, risk-mitigating activity that results in no net short economic exposure to a particular issuer, securities based on broadly-defined indexes, and the "Broker-Dealer" exemption in the Proposed Modified Uptick Rule (201(c)).[32] Furthermore, we believe that market-on-close orders should fall under the same exemptions as VWAP orders as both order types are not assigned a price until after the close of trading, and neither can be used in facilitating the kind of manipulative behavior the proposed restrictions intend to prevent.

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[31] June 19 Letter at 7.

[32] Id. at 9.

16. *The Proposal includes a discussion of estimated annual reporting and recordkeeping burdens with respect to provisions of the proposed rules that would require a new "collection of information" under the Paperwork Reduction Act of 1995. We invite comment on these estimates with respect to the alternative uptick rule.*

As discussed above, while we anticipate that some broker-dealers will be able to leverage some portion of their Regulation NMS compliance infrastructure, we also anticipate significant implementation costs for the proposed rules. In both cases we anticipate the generation and retention of voluminous compliance reports.

17. *The Proposal includes a discussion of estimated costs and benefits of the proposed rules. We are sensitive to the costs and benefits of the alternative uptick rule, and encourage commenters to discuss any additional costs or benefits specific to the alternative uptick rule and/or beyond those discussed in the Proposal, as well as any reduction in costs. What would be the costs and benefits of the alternative uptick rule versus the proposed modified uptick rule, the proposed uptick rule, the circuit breaker halt rule or a circuit breaker triggering either the proposed modified uptick rule or the proposed uptick rule? What would be the general costs and benefits of short sales being subject to the alternative uptick rule? Commenters should provide analysis and data to support their views of the costs and benefits associated with the alternative uptick rule.*

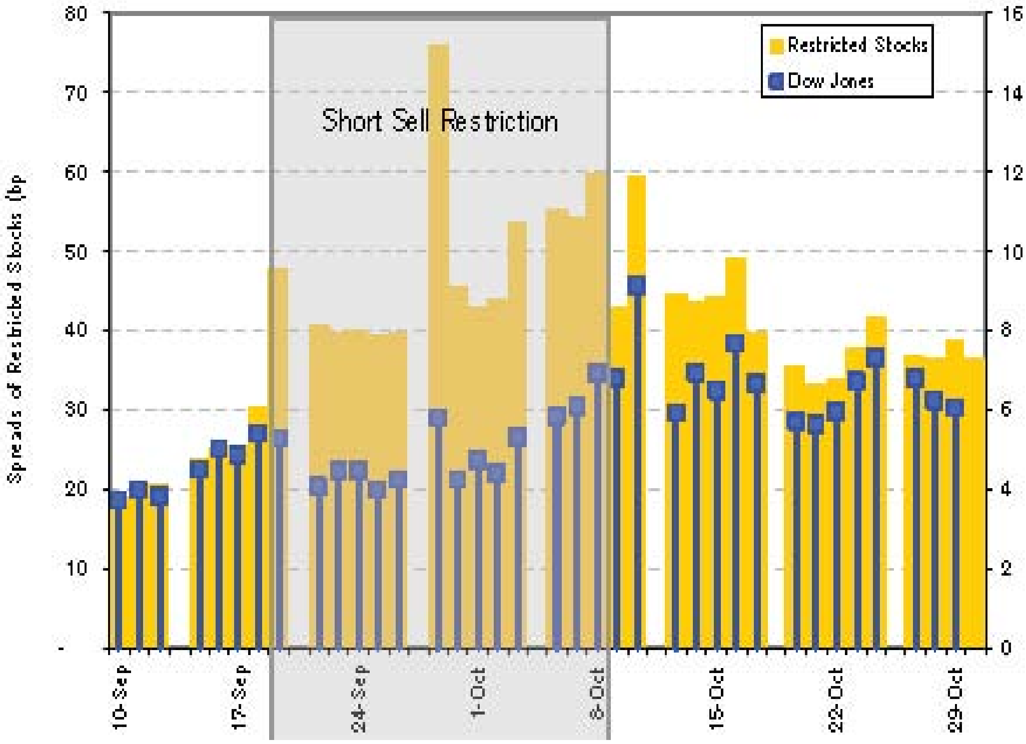
18. *The Proposal includes a discussion of whether the proposed rules would promote efficiency, competition, and capital formation. We request comment on whether the alternative uptick rule would likely promote efficiency, capital formation, and competition.*

19. *The Proposal includes an Initial Regulatory Flexibility Analysis ("IRFA"), in accordance with the provisions of the Regulatory Flexibility Act, regarding the proposed rules. We solicit written comments regarding our IRFA analysis. In particular, the Commission seeks comment on the number of small entities that would be affected by the alternative uptick rule. We request that commenters provide empirical data to quantify the number of small entities that could be affected by the proposed amendments. We request comment on whether the proposed amendments would have any effects that we have not discussed. We also request that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of the impact.*

20. *A number of commenters stated that their first preference would be for the Commission not to adopt any of the short sale regulations set forth in the Proposal, and this option along with the alternative uptick rule and all other options discussed in the Proposal are under active consideration. We request comments on the position that the best result for investors and the markets would be for the Commission not to adopt any additional short selling regulations at this time. If the Commission determines that additional short selling regulations are necessary, what option, including the alternative uptick rule, would produce the best result for investors and the markets?*

As discussed above, we believe that the best result for investors and the markets would be for the commission not to adopt any short selling *restrictions* at this time – such restrictions are not necessary and will impair the functioning of the markets, particularly market making and liquidity provision. We do believe that additional short selling regulations may be warranted in order to provide the Commission with accurate and detailed data on market activity. For example, while FINRA receives detailed daily information from every broker-dealer on every single order placed in NASDAQ securities, there is no similar system for NYSE-listed issues. Providing this information to the Commission would permit comprehensive and timely surveillance and significantly streamline the investigative process.

<u>Appendix B: Impact of Short Sale Restrictions on Bid/Offer Spreads</u>



Source: Credit Suisse Portfolio Strategy, AES Analysis, November 12, 2008.

Appendix C

EWT
LLC

June 19, 2009

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

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

Dear Ms. Murphy:

EWT, LLC ("EWT") appreciates the opportunity to provide the Securities and Exchange Commission (the "Commission") with comments on the proposed amendments ("Proposed Amendments") to Regulation SHO under the Securities Exchange Act of 1934 (the "Exchange Act"). Release No. 34-59748, 74 Fed. Reg. 18042 (Apr. 20, 2009) (the "Release").

I. Overview

EWT strongly supports the Commission's efforts to restore investor confidence in U.S. financial markets, including through appropriate measures to limit abusive short selling. Critical to investor confidence, in our view, is the preservation of the deep liquidity that investors have come to expect in U.S. markets for publicly traded securities – liquidity that depends crucially on committed market making firms.

- Bona fide market makers – in notable contrast to directional short sellers who bet on market declines – create trading opportunities for investors by buying and selling securities in both advancing and declining markets.

- Market making firms offer investors one of the most important kinds of confidence – the confidence that when they seek to sell or buy a security, good markets or bad, someone will be there to buy or sell it.

Thus, it is essential that Commission rules protect the ability of market makers, when genuinely serving as liquidity providers, to offset their risks on both sides of the market, long and short.

Investor confidence also rests importantly on orderly and rational relationships across markets and products. Gaps between the behavior of indices and their underlying components, or in the movements of commodities and futures prices for comparable instruments, can significantly undermine faith in the stability of those markets. The Commission therefore should ensure that its rules do not create or exacerbate instability by imposing unnecessary or inconsistent restrictions on broad based index or other products traded in multiple forms and venues.

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II. Background

EWT is a proprietary, self-clearing broker-dealer registered with the Commission under Section 15 of the Securities Exchange Act of 1934. EWT is a member of the Financial Industry Regulatory Authority, the New York Stock Exchange, NASDAQ and, together with its affiliates, operates across more than 25 other exchanges and market centers around the world. Engaging in direction-neutral algorithmic trading and using proprietary trade execution technology, EWT has a significant market share in several asset classes and is a major, active participant in the public equities markets. EWT does not engage in customer transactions and derives its income from its proprietary market making activities. As a market maker, EWT provides significant liquidity to the marketplace and investors. It does not seek to profit from "bets" on downward market movements, through short sales or otherwise.

As an active participant in the equities market, EWT strongly supports the efforts of the Commission to maintain and promote fair and orderly markets through carefully considered rule-making. Recent actions of the Commission and its staff to address concerns about the spreading of false rumors, abusive "naked" short selling,[1] and other manipulative conduct, as well as concurrent initiatives to address equities settlement and failures to deliver, have had an immediate impact.[2] Coupled with rigorous enforcement, such activities ensure the integrity of our public equity markets, and this integrity ultimately forms the bedrock of investor confidence.

The foundation of market integrity and investor confidence is a sound rule-making process. Investors from all corners of the globe choose to invest their savings with confidence in our country's financial markets because they know that these markets are governed by fair and transparent rules in a manner which is unparalleled elsewhere. The multi-year process which resulted in the July 2007 removal of short sale price test restrictions was a model of careful, deliberate, and transparent rule-making, including extensive public participation, rigorous application of econometric analysis, and the very practical and scientific approach of

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1 An "abusive 'naked' short sale" is not defined in Regulation SHO, but we understand it to be a short sale made without having stock available for delivery (or locating such stock) and then intentionally failing to deliver stock within the standard three-day settlement cycle. The Commission has previously provided guidance in this regard in Release No. 34-56212 (Aug. 7, 2007), 72 Fed. Reg. 45544 (Aug. 14, 2007), and Release No. 34-54154 (July 14, 2006), 71 Fed. Reg. 41710 (July 21, 2006).

2 Recent data indicates that interim final temporary Rule 204T has been quite successful in meeting its goal of reducing persistent fails to deliver. However, technical details of the Rule have resulted in unintended adverse consequences including a significant and troubling reduction in credit available to broker-dealers, and substantially increased market volatility around the open and close of trading. We discuss these consequences in our November 25, 2008, comment letter on Rule 204T, where we present simple technical remedies to address these issues should the rule be adopted on a permanent basis. Letter from Peter Kovac, Chief Operating Officer and Financial and Operations Principal, EWT, to Florence Harmon, Acting Secretary, SEC, dated November 25, 2008.

conducting a pilot program to test various hypotheses regarding the impact of proposed regulation on market microstructure.[3]

While we strongly urge the Commission to apply the same rigorous standards of analysis when evaluating the Proposed Amendments as it did in its July 2007 process, we recognize nevertheless that under today's extraordinary circumstances and constraints, the options are limited. In our comments below, we thus focus solely on certain technical aspects of the Proposed Amendments which we feel are essential to maintaining fair and orderly markets. In particular, while the Proposed Amendments are intended to promote investor confidence by curtailing abusive short selling on the securities of individual issuers, without the proper exemptions the amendments will unnecessarily restrict bona fide market making and risk-mitigating hedging activities, both of which are fundamental to the market integrity and stability upon which investor confidence depends.

III. Market Makers and Market Integrity

Bona fide market making is an essential part of the financial markets. The role of market makers is, in fact, to ensure that there *are* financial markets – market makers create a two-sided market for securities, enabling investors to buy or sell at a fair price. This most basic function of the markets is among the cornerstones of investor confidence.

The service market makers provide is distinct from other investment and trading activity in that a market maker does not seek to profit from speculation that a security will increase or decrease in value. In the rule-making process, it should be recognized that there is an important distinction between speculative activity regarding an individual security, and non-speculative activities such as bona fide market making. This fundamental distinction has been

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3 The extensive history of public participation in and comment on the July 2007 removal of short sale price restrictions is covered in the Release (74 Fed. Reg. at 18042, 18044-46). In addition to numerous academic studies of the data, the Commission received 27 comment letters; only two commenters opposed the removal of short sale price restrictions. Not surprisingly, despite all the recent hyperbole surrounding the repeal of the uptick rule, there has not yet been a credible critique of either this rule-making process, nor of the underlying rationale for the removal of short sale price restrictions. Critics who cite a correlation between increased volatility and the removal of short sale price restrictions misinterpret the data and, more fundamentally, confuse correlation with causality. During the Reg SHO Pilot period, when short sale price restrictions were removed from fully one-third of the stocks in the Russell 3000, the market trended upward and volatility generally trended downward. Both trends only reversed with the eruption of the sub-prime mortgage crisis in the summer of 2007. *See* Credit Suisse Portfolio Strategy, AES Analysis (April 23, 2009). Just as the removal of the restrictions in 2004 did not drive the market upward, the completion of the removal of the restrictions in 2007 did not drive the market downward. The common-sense distinction between correlation and causality is further demonstrated by the fact that the equities markets plummeted more than 20% in March of 1938, one month after the adoption of the original short sale price restrictions – few rational observers would attribute that broad market decline to the adoption of short sale price restrictions.

implicit in the discussion to date, and no serious commenter has claimed that market making and risk mitigating hedging activities have anything but a dampening effect on market volatility, but it bears repeating that market making has a significant beneficial impact and ought not to be discouraged through unnecessary and adverse regulation.

A. Role of Market Makers

More than anything else, investor confidence is dictated by the investor's actual interaction with the market. It is a testament to the soundness of our financial markets that investors unquestioningly expect that they can buy or sell exchange-listed equities at any time in a fair and liquid market. However, in the broader context of all financial markets, this experience is the exception, not the norm. Numerous other markets lack competitive two-sided markets, and the inability of investors to transact in these markets over the past year has seriously eroded confidence in those markets.[4] The erosion of investor confidence in the basic functioning of the markets is a serious concern, for the ultimate crisis of confidence – a "run" on the bank – is sparked by a fear that transactions can no longer occur. The ability to transact freely in a market is a basic and fundamental component of investor confidence.

The role of the market maker is to provide a continuous and regular two-sided quotation to the market. The market maker's actions ensure that the individual investor is able to transact freely in the market, which is a fundamental prerequisite of investor confidence. Moreover, the investor's knowledge that tomorrow, just like today, there will be a competitive and fair two-sided quotation in the markets, provides the confidence that is the best defense against a "run" on the bank sparked by the fear of the market disappearing.[5]

Competitive market making not only facilitates price discovery, but also creates significant depth of liquidity in terms of both shares available for purchase or sale, and shares available at multiple price points. This depth of liquidity dampens volatility in the market: with multiple market makers willing to buy thousands or tens of thousands of shares it becomes less likely that a handful of transactions can move the market in any direction. Just as the unpredictability and volatility of a market weakens investor confidence, the dampening of

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4 For example, the freezing of the markets for auction rate securities in 2008 severely undermined investor confidence in that market. *See* New York Times, "New Trouble in Auction-Rate Securities", Feb. 15, 2008; *see also* Speech by Erik R. Sirri, Director of Trading and Markets, SEC, to the 2008 Bond Attorney's Workshop of the National Association of Bond Lawyers, September 17, 2008 (noting concern about "damage the liquidity freeze up in [auction rate securities] has caused to investor confidence in general"). Also, in 2008 the Federal Reserve had to intervene directly into the commercial paper market in order to prevent a freeze up in that market from causing a "run" on the entire financial system. *See* New York Times, "Fed Announces Plan to Buy Short-Term Debt", Oct. 7, 2008.

5 On the afternoon of "Black Monday", October 19, 1987, rumors that the NYSE would be closed on the following day prompted "further sales as traders reportedly worried that a market close would lock them into their existing positions." Mark Carlson, Federal Reserve Board of Governors, "A Brief History of the 1987 Stock Market Crash with a Discussion of the Federal Reserve Response", citing the Wall Street Journal, "Managing a Crisis", Oct. 21, 1987.

volatility serves to bolster investor confidence. The deep liquidity provided by market makers also serves as the first line of defense against market manipulation, as a would-be manipulator would have to transact thousands or tens of thousands of shares to move the price by even a penny. We believe it is no coincidence that the majority of market manipulation cases prosecuted by the Commission involve thinly-traded securities lacking competitive market makers. As the Commission is well aware, the prevention of (even more so than the prosecution of) market manipulation is a crucial component of investor confidence.

Today's market makers often transact across multiple products and asset classes, preventing discontinuous or disconnected price discovery among cash equities, futures, Exchange Traded Funds ("ETFs"), and other derivatives markets. A market maker's ability to efficiently harmonize pricing across disparate markets, and thereby extend the depth of liquidity in any one market to other markets, substantially mitigates the systemic risk endemic to extraordinary market volatility. Moreover, synchronizing and consolidating price discovery across these disparate markets is critical to investor confidence.[6] As few individual investors have direct access to or the requisite knowledge to transact in the myriad of derivatives markets, it is important that market makers maintain consistent pricing across asset classes to ensure that market professionals do not have unfair access to alternative markets and pricing. Investor confidence relies upon true price discovery, even if the investor is unable to access each and every market.

Finally, it is important to note that, for purposes of the Commission's short sale rules, what defines a market maker is not and should not be an arbitrarily awarded registration or designation, but rather bona fide market making activity. As noted in the Commission's October 17, 2008, Amendments to Regulation SHO, the determination of whether or not selected activity constitutes bona-fide market making should be based on the facts and circumstances of the activity itself.[7] While in different market contexts different factors may be relevant, we believe – based on the discussion in the October 17 Amendments and our own experience and recent analysis of liquidity provision in today's electronic markets – that the factors indicative of bona fide market making include whether or not the market participant:

* Displays quotes on publicly accessible exchanges or ATSs;
* Quotes on a continuous and regular basis;

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6 One of the factors that exacerbated the 1987 market crash was the "de-linkage" of the cash and futures markets in which there was a significant deviation in the price of S&P 500 index futures and the actual S&P 500 stocks, sowing confusion and severely undermining confidence in both markets. *See* Report of the Presidential Task Force on Market Practices (the "Brady Report") at 59 (Jan. 8, 1988) (noting that the failure of "market segments to perform as one market contributed to the violence of the market break in October 1987").

7 Release No. 34-58775 at 32 (Oct. 14, 2008), 73 Fed. Reg. 61690 at 61699 (Oct. 17, 2008) (the "October 17 Amendments").

* Quotes both sides of the market generally at or near the market, or near fair value (e.g. Net Asset Value for ETFs, underlying value for depository receipts, etc.), on a regular basis;

* Incurs economic or market risk (i.e. is not solely acting as a riskless principal);

* Provides liquidity to a security's market on a regular basis;

* Takes the other side of trades when there are short-term buy-and-sell-side imbalances;

* Quotes multiple price points, preventing excess volatility through depth of liquidity; and/or

* Trades without long or short bias, in a pattern that demonstrates minimal net economic exposure in a particular security (e.g. buys and sells in roughly comparable amounts; or purchases of securities, hedged with other securities or security derivatives).

We note that these factors are not an exclusive list, and that bona fide market making activity may exhibit some or all of the characteristics above and should be evaluated on a facts and circumstances basis.[8] Most importantly, the Commission has clearly described activities that do not qualify as bona fide market making (e.g. "activity that is related to speculative selling strategies or investment purposes of the broker-dealer"), setting clear and narrowly-defined boundaries.[9] In the same spirit, we strongly support the Commission's efforts to distinguish between bona fide market making activity and market making firms. We believe that the activity itself should be protected through proper exemptions, but that entire firms should not operate under such exemptions merely based on a registration or occasional market making activity.

B. <u>Impact of the Proposed Amendments on Market Making</u>

The Proposed Amendments will impact the activities of market makers in a wide variety of market conditions. Although it has been posited that activities conducted in "advancing markets" will be spared, we do not believe this will be the case. First, it is our experience that even markets generally trending upward do not uniformly move in one direction,

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8 The list of factors is based on the list in the October 17 Amendments (73 Fed. Reg. at 61698-99), but modified based on our own experience and analysis of liquidity provision in today's electronic markets.

9 October 17 Amendments, 73 Fed. Reg. at 61699.

and thus the term "advancing market" is illusory in the context of market microstructure. Second, no market participant can accurately predict whether or not the market will be advancing or declining in the next second or minute. Therefore, under the Proposed Amendments, a market participant would not be able to predict whether the "firm" quotation displayed in the market would truly be actionable one second later – the validity of the quote would not depend on the price, but on external factors that are unknowable *a priori*. For example, if a market making firm was at that instant short and saw a bid in the market, whether or not the market maker could actually transact with that bid would depend on the vagaries of other market participants' quotations, a potentially ephemeral situation that can change from millisecond to millisecond, and even when an order is "in transit" to the exchange to be executed.[10] While the market maker might have been able to transact on the bid one second ago, a flicker in the National Best Bid of Offer ("NBBO") in the interim could have subsequently rendered that bid untouchable unless and until the NBBO flickers back to its previous state.

This uncertainty has a profound impact on market making. As market makers continuously stand ready to buy or sell securities and assume the related risk of these positions, market makers must carefully analyze opportunities to hedge their risk at all times. However, if a market maker can no longer trust that the quotation currently displayed may be actionable when it needs to hedge the risk exposure, the market maker by default assumes significantly more economic risk and compensates for this with a wider bid/offer spread.[11] In this way, individual investors are made to assume the incremental cost of the additional risk the market maker is forced to bear.[12] Additionally, market makers may also seek to mitigate this additional risk through reducing the size of the quotations, resulting in increased volatility and trading costs. In some cases, the market maker may find it economically infeasible to assume the additional risk created by this inefficiency, and may simply withdraw entirely.

Moreover, if additional short sale restrictions are imposed after a particular security has declined in value by a significant percentage, the potential impact may be worse. If a security has suffered a significant decline, additional constraints that affect the ability of market makers to provide high-quality markets may actually hasten the decline, as decreased size and wider spreads will further undermine already battered investor confidence in the security. Further, should market makers be unable to fulfill their role due to an outright ban on short sales,

10 A troubling side-effect of this is that an investor who entered the limit order to buy may not be able to execute his or her order even though there is a willing counterparty, frustrating their effort to purchase securities.

11 We note that market makers frequently hedge their risk exposure through transactions in related but distinct securities, and thus a "circuit breaker" approach does not necessarily limit the scope of the restrictions to a single security – a halt in a security used as a hedge for market making activity may thus impact markets in many securities.

12 The Office of Economic Analysis report on the September 2008 short selling restrictions supports this conclusion, noting that "restricting short sales that provide liquidity or react to price overreaction might result in higher transaction costs and higher volatility." Office of Economic Analysis, Memorandum Re: Analysis of Short Selling Activity during the First Weeks of September 2008 at 1 (December 16, 2008).

the absence of their liquidity will increase the security's exposure to manipulative activity, and the disappearance of quotes may serve to trigger the very "run" on the bank that the Proposed Amendments are intended to prevent.

Finally, it is important to note that the widening of bid/offer spreads and reduction of liquidity in the public markets is likely to accelerate the flight of institutional and professional trading volume to "dark pools" and broker "internalization" facilities. Regulation NMS has been a potent force in consolidating price discovery and liquidity in fair and transparent public markets. As volume and competition increased in these markets, it became increasingly difficult for brokers to "internalize" customers orders due to the best execution requirements of Regulation NMS, and even more volume migrated to the public markets. However, a widening of bid/offer spreads and decrease in liquidity provided by professional market makers could reverse the consolidation of liquidity in the public markets, permitting some brokers once again to take advantage of decreased competition in price discovery and offer substantially inferior (but still technically legal) internalization prices to their customers.

In sum, we believe that if any of the Proposed Amendements were adopted and did not include the proper provisions in support of bona fide market making, it will result in impaired price discovery, wider bid-offer spreads (at a greater cost to investors), less overall liquidity, and an increase in the flight of liquidity from the public markets to dark pools and internalization facilities – a series of consequences that individually and jointly will severely undermine investor confidence.

IV. Recommendations

In light of the concerns described above, we urge the Commission to review fully the implications of the Proposed Amendments and determine what the most appropriate approach is to meet the stated goals of limiting the potential impact of speculative or directional short selling in declining markets, while concurrently maintaining the fair and orderly markets upon which investor confidence ultimately relies. EWT believes that the single most important issue for the Commission in this regard is not the mechanism by which short sale restrictions would be implemented, but rather that any such restrictions be narrowly tailored to avoid adversely affecting non-directional activities such as market making and risk mitigating hedging.[13] Such discretion will protect that the liquidity and integrity of our markets, upon which investor confidence depends.

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13 Although we believe that each of the proposed implementation mechanisms have certain disadvantages, we believe that the approach with the fewest adverse consequences for the market would be the proposed modified uptick rule based on current bid data. The uptick rule based on last sale data is unworkable in today's decentralized markets, and the circuit-breaker approaches may exacerbate market dislocations by suddenly and unexpectedly altering the regulatory regime and liquidity characteristics of a particular security, precisely when it is under duress. Regardless, the myriad of permutations makes succinct analysis

We respectfully request that the Commission consider, in particular, each of the modifications we suggest below, which we believe preserve the central objectives advanced by the Commission and which we have ranked in order of importance:

(1) The Commission should implement an exemption from any short sale price restrictions for bona fide market making activity. This targeted exemption would permit market makers to continue to provide competitively priced liquidity, ensuring functioning markets, the cornerstone of investor confidence.

(2) The Commission should implement an exemption from any short sale price restrictions for activity that results in no net short economic exposure for a particular issuer (e.g. an equities position hedged with equivalent futures, an ETF position hedged with the components of the ETF, a depository receipt hedged with the underlying security). This would permit a very narrow range of risk mitigating trades while protecting the issuer from any true directional pressure. Risk-mitigating hedging is a key stabilizer in turbulent markets, and restricting the ability to reduce one's risk would be a serious blow to investor confidence. We note that both the United Kingdom's Financial Services Authority and the Netherlands' Authority for the Financial Markets adopted this approach in their recent short selling restrictions as well.

(3) The Commission should implement an exemption for securities based on broadly-defined indices, such as ETFs and closed-end funds. By definition, these instruments do not reflect upon a single issuer; moreover, they are frequently used in risk mitigation as a hedge for unwanted risk. As mentioned above, the ability to reduce one's risk is a critical component of investor confidence.

(4) The Commission should implement the proposed "broker dealer provision" as defined in the Proposed Modified Uptick Rule (201(c)), which permits the broker dealer to verify compliance with the bid test on order submission. Without this exemption, an exchange receiving lagged or stale market data from another exchange may incorrectly refuse to execute a directed order, creating directly contradictory requirements between Regulation NMS (which requires routing the order to the exchange) and Regulation SHO (which requires the exchange to reject the order) for the broker dealer.

Finally, we hope that any implementation of the Proposed Amendments will include a pilot test similar to the test employed in 2004, so that an accurate measurement of the costs and benefits of these actions may be conducted.

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difficult, and we hope there will be additional opportunity to comment once a single approach is selected but prior to adoption.

More generally, as market sentiment eases, we urge the Commission to maintain its broad perspective in evaluating Regulation SHO, and to continue its extensive monitoring of short sales and other market data. The evolution of Regulation SHO over the past several years has generally reflected the Commission's balanced and thoughtful approach to the complex issues raised by short sales. We believe that a careful targeting of its provisions, rather than sweeping market restrictions that risk substantial unintended consequences, offers the greatest protection for improved future market stability.

EWT appreciates the opportunity to comment on the Proposed Amendments and would be pleased to discuss any of the comments or recommendations in this letter with the Commission staff in more detail. If you have any questions, please do not hesitate to contact the undersigned at (310) 651-9746.

Sincerely,

Peter Kovac
Chief Operating Officer and
Financial and Operations Principal

cc: Mary L. Schapiro, Chairman
Kathleen L. Casey, Commissioner
Elisse B. Walter, Commissioner
Luis A. Aguilar, Commissioner
Troy A. Paredes, Commissioner

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