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October 7, 2009

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

Re: ***Proposed Modifications to Regulation SHO, Release No. 34-59748; File No. S7-08-09***

Dear Ms. Murphy:

The NASDAQ OMX Group, Inc. ("NASDAQ OMX") welcomes the opportunity to comment on the proposed amendments to Regulation SHO issued by the Securities and Exchange Commission ("Commission") on April 10, 2009, and supplemented on August 17, 2009.[1] NASDAQ OMX, the world's largest stock exchange company, the operator of five domestic self-regulatory organizations and one network processor, and representative of over 3000 listed companies, has a material interest in the development and application of short sale regulations that serve and protect investors, issuers, and market participants.

As noted in our earlier comment[2] and testimony[3] the Commission is walking a narrow path in trying to separate abusive short selling from legitimate short selling. Abusive short selling – attempts by speculators to artificially push down stock prices through selling short – harms investors and the companies listed on our exchanges and

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1 *See* Securities Exchange Act Release No. 59748 (Apr. 10, 2009), 74 FR 18042 (Apr. 20, 2009) ("Short Sale Proposing Release") and Securities Exchange Act Release No. 60509 (Aug. 17, 2009), 74 FR 42033 (Aug. 20, 2009).

2 *See* Letter, dated March 24, 2009, from Robert Greifeld, Pres. & CEO, The NASDAQ OMX Group, Inc., Duncan Niederauer, CEO, The NYSE/Euronext Group, Inc. Joe Ratterman, CEO BATS Exchange, Inc., and Joseph Rizzello, CEO, National Stock Exchange to Mary Schapiro, Chairman, Commission ("March 2009 Comment Letter").

3 *See* Opening Statement of Dr. Frank Hatheway, Chief Economist, NASDAQ, at SEC Roundtable of May 6, 2009.

erodes confidence in U.S. capital markets. Legitimate short selling, in contrast, provides needed liquidity and price discovery that makes U.S. markets the most orderly, efficient, and fair capital markets in the world. Continually attacking abusive short selling and other manipulative activities will help re-establish public trust in the U.S. financial system, but unnecessary short sale restrictions can impede capital formation by reducing liquidity, widening spreads, and increasing volatility.

Empirical data and incremental improvements are the keys to striking the optimal balance in regulating short selling. The model here is the Commission's success in reducing "fails to deliver" that are the primary measure of abusive, naked short selling. Based on studies of empirical data, the Commission adopted measures to restrict and penalize brokers and their customers for failing to deliver securities, culminating most recently in Rule 204 under Regulation SHO.[4] The Commission achieved success through incremental, narrowly-tailored regulatory changes addressing specific, well-documented regulatory gaps that enabled abusive, naked short selling. As a result, empirical data shows that the number of securities with significant failures to deliver on the "Threshold" lists have declined by over 98%, from over 400 prior to the adoption of the Rule 204T to fewer than 20 today.

NASDAQ OMX supports the Commission's continued focus on reducing delivery failures and abusive short selling, and its approach of careful analysis of empirical data followed by incremental regulatory responses. In that vein, NASDAQ OMX Chief Executive Officer Robert Greifeld has publicly urged the Commission to consider adopting a "hard locate" requirement.[5] The hard locate requirement would augment current rules and risk-based limits by placing a fixed regulatory cap on the number of locates per share that holders could issue. A well-constructed hard locate requirement would be a powerful, yet flexible tool for the Commission to reduce the instances and harms of abusive short selling made possible by excessive lending, while still preserving the benefits of price discovery and liquidity made possible by prudent lending. The hard locate requirement would be another logical incremental step towards reducing delivery failures.

Unlike the evidence of delivery failures supporting Rule 204, there is no compelling evidence upon which to base new restrictions on short selling. At the Roundtable to Examine Short Sale Price Test and Circuit Breaker Restrictions and in numerous public appearances, the Chairman and Commissioners have stressed the importance of empirical data to support additional short sale restrictions. Despite these urgent calls for empirical data, there appears little in the record now before the

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4 *See* Securities Exchange Act Release No. 58572 (Sept. 15, 2008); Securities Exchange Act Release No. 58166 (July 15, 2008).

5 *See* Testimony of Dr. Frank Hatheway, SEC Roundtable on Securities Lending and Short Sales, Controls on "Naked" Short Selling: Examination of Pre-Borrow and Hard Locate Requirements, September 30, 2009.

Commission demonstrating that additional restrictions on short sales would achieve any of the Commission's stated objectives. Nor is there empirical evidence in the record showing that the absence of a short sale price test caused or accelerated market declines during the financial crisis in the summer and fall of 2008, or that the presence of a price test would have averted or ameliorated the declines. To the contrary, studies by the Commission's Office of Economic Analysis ("OEA") and other sources indicate that short sale restrictions, including those adopted during last year's financial crisis, do not achieve their intended goals, and instead reduce overall market efficiency.

If the Commission nonetheless determines that empirical data justifies imposing additional restrictions on short selling, NASDAQ OMX suggests employing the same incremental approach taken to address delivery failures. Any additional regulation of short selling must be narrowly tailored to address only the problem that the data reveals, rather than an over-broad rule in search of a problem. It must balance liquidity, transparency, and price discovery to best benefit all market participants. Any incremental regulation must also acknowledge the link that exists between domestic and global markets, and between multiple asset classes. Short selling in equities and options are closely linked, and those are closely linked to index products, futures and other derivatives. As a result, regulation of one asset class impacts linked asset classes, and domestic regulation can impact global trading patterns.

Recognizing the need to balance liquidity, transparency, and price discovery, and the links between asset classes and global markets, the most aggressive step the Commission can take at this time is to adopt a Circuit Breaker test. To the extent it is justified by empirical data, NASDAQ OMX supports imposing a Circuit Breaker such as NASDAQ OMX proposed in its March 2009 Comment Letter and that the Commission described in its proposing release. Specifically, NASDAQ OMX supports a Circuit Breaker that would be triggered when an individual stock experiences a decline of 20 percent from the previous day's official closing price as disseminated by the network processors and that would remain in place until the end of the trading day on which it was triggered.

Our national markets and many foreign markets have successfully used circuit breakers on individual securities and broad indexes for many years. A Circuit Breaker permits normal market activity while a stock is trading in a natural range and short selling is more likely to benefit the market (by, for example, increasing price discovery and liquidity). Conversely, a Circuit Breaker will restrict short selling when prices begin to decline substantially and short selling becomes more likely to be abusive and potentially harmful. The Circuit Breaker is particularly efficient in stable and rising markets because it avoids imposing continuous monitoring and compliance costs where there is little or no corresponding risk of abusive short selling.

If the Commission chooses to act at all, taking an incremental step such as a Circuit Breaker is much preferable to the drastic step of adopting an "always on" price test. The Circuit Breaker is narrowly-tailored to instances where there is some evidence of abusive short selling, the problem that the Commission is attempting to address. A price test, on the other hand, is overbroad and would hinder all short selling including legitimate short selling that provides needed liquidity and price discovery. The Circuit Breaker would necessarily trigger false positives, for example where a stock declines in price due to material concerns about the issuer. Those false positives would be miniscule compared to the cost of restricting short sales in all stocks at all times as a price test would do.

The Circuit Breaker is a flexible regulatory tool because each of its parameters can be modified based on continued application and study. For example, NASDAQ OMX believes that a Circuit Breaker triggered by a 20 percent price decline sufficiently addresses the Commission's concerns about abusive short selling. If, however, a 20 percent price decline is later determined to be ineffective, the trigger can be easily and quickly reset to 15 or even 10 percent. Similarly, while NASDAQ OMX believes that the Circuit Breaker trigger should be based upon the previous day's official closing price, it can be quickly reset to use the official opening price in the event that using the official closing price captures excessive false positives based upon news-based price movements. Even the duration of the Circuit Breaker can be adjusted if the Commission determines that the initial duration selected (NASDAQ OMX recommends the remainder of the trading day) is over- or under-inclusive.

This flexibility is critical to the Commission's continued successful use of incremental regulatory modifications. Having this flexibility will enable the Commission to respond quickly in the event that speculative fears about short selling actually do materialize in the future. For example, currently there is no clear evidence supporting speculation by some commenters about a "magnet effect" where sellers – both long and short – push a stock to its Circuit Breaker out of fear of being unable to sell short once the Circuit Breaker is triggered.[6] If the Commission implements the Circuit Breaker and later identifies evidence that a magnet effect exists, it can counter that effect by adjusting the trigger, the duration, or the restrictiveness of the Circuit Breaker.

A price test should be imposed only after a Circuit Breaker is triggered. An "always-on" price test effectively ***targets*** legitimate short selling that is generally agreed to provide liquidity and price discovery rather than focusing on the abusive short selling about which the Commission is concerned. NASDAQ OMX opposes any measure that purposefully targets legitimate short selling in this manner, particularly in the absence of empirical data compelling such restrictions. Based upon the current record, there is

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[6] *See* Harris, Larry. *Trading & Exchanges: Market Microstructure of Practitioners* pages 572-580. New York: Oxford University Press, 2003, Kim, Yong H., J. Jimmy Yang, 2004, What Makes Circuit Breakers Attractive to Financial Markets? A Survey, *Financial Markets, Institutions & Instruments* 13, 109-146, and Abad, David, and Roberto Pascual, 2007, On the Magnet Effect of Price Limits, *European Financial Management* 13, 883-852.

absolutely no basis for the Commission to adopt a price test without also adopting a Circuit Breaker.

In contrast to an always-on price test, a post-Circuit Breaker price test of any variety has a dramatically smaller impact on overall trading than a test that is applicable at all times to all stocks. Therefore, the choice of a price test that would follow a Circuit Breaker has a proportionately smaller risk of unintended consequences or liquidity and price discovery reduction than an "always on" price test. NASDAQ OMX continues to believe that when a Circuit Breaker is triggered, short sales should be subject for the remainder of that trading day to the Modified Uptick Rule that NASDAQ OMX and others proposed in the March 2009 Comment Letter for the reasons set forth in that Letter.[7]

In NASDAQ OMX's unique experience operating multiple exchanges and a network processor, a Circuit Breaker and post-Circuit Breaker price test is not appreciably more time-consuming to implement than an always-on price test alone. Having removed price test functionality from all systems in 2007, the industry will be required to expend significant resources implementing any price test whether the Commission adopts a price test alone or a price test plus a circuit breaker. Once the price test is in place, there is minimal incremental effort required to add a Circuit Breaker that controls the application of the price test. Any slight increase in implementation time that a Circuit Breaker necessitates is sufficiently justified by the advantages of a Circuit Breaker over an always-on price test particularly considering the expected loss of liquidity, widening of spreads and decline in price discovery associated with an always-on price test.

The Circuit Breaker is also simple to implement because it is triggered from a central source. Existing Circuit Breakers are generally measured and triggered by a single market source, such as an exchange or a network processor. The single source can issue one announcement that is broadcast to all market participants over a single data feed. This mechanism is already in place for regulatory halts and existing Circuit Breakers with which the markets are already quite familiar.

The long-term implementation challenge will be regulatory rather than technological and it will be equally challenging whether the Commission adopts a price test or Circuit Breaker plus price test. A price test will create the same complexities that

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[7] Under the Modified Uptick Rule, short selling can only be initiated at a price ***above*** the highest prevailing national bid by posting a quote for a short sale order priced above the national bid. As such, the execution of a short sale would occur only at a higher price than the prevailing market at the time of initiation, and only on a passive basis (i.e., short sales cannot hit bids). This restriction would greatly assist the prevention of manipulative short selling, which is so harmful to the markets.

accompanied implementation of the order protection rules of Regulation NMS under the Exchange Act. The order protection rule required substantial programming by the network processors, the exchanges and firms. Unavoidable latency issues continue to complicate its application and enforcement, necessitating detailed policies and procedures to overcome. A price test will raise similar latency issues, potentially enabling one market to execute a short sale that another market could not. While market participants would leverage their experience with Regulation NMS to compensate for such issues, a single source making a single announcement is significantly simpler than a price test.

The more restrictive the price test the Commission chooses to adopt, the more important it become that the Commission also adopts exceptions parallel to those set forth in former Rule 10a-1 as well as a market maker exception as set forth in former NASDAQ Rule 3350.[8] The previous exceptions and exemptions from SEC Rule 10a-1 and NASDAQ Rule 3350 operated for many years without undermining the policy objectives of the rule. The NASDAQ Bid Test included a market maker exemption for its entire operative period from 1994 until 2007 with no evidence of abuse by market makers. Under Rule 204T (now Rule 204) of Regulation SHO, the Commission itself recognized the benefit of a limited exception from the close-out requirement for fails to deliver attributable to bona fide market making activities. Given the longstanding recognition of a market maker exception and the lack of empirical evidence that market makers abused the exception or engaged in abusive naked short selling, there is no justification for removing that exception in the event the Commission determines to re-impose a price test.

Lastly, the impact of adopting a circuit breaker or price test will be magnified by the Commission Staff's recent decision to update the "Responses to Frequently Asked Questions Concerning Regulation SHO." The staff recently issued FAQs 2.4 and 2.5 regarding the requirements for marking of sell orders.[9] It is NASDAQ OMX's understanding based upon conversations with member firms that the FAQs will result in a material increase in the number of orders marked short and a corresponding increase in the number of shares sold short (which may actually be long sales). The FAQs have already created some confusion in the industry and could cause considerably more if a

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8 NASDAQ OMX hereby reiterates the strong support it has already expressed for an exemption for options market makers from any price test the Commission chooses to adopt. *See* Letter to Elizabeth Murphy, Secretary, SEC from Boston Options Exchange, Chicago Board Options Exchange, International Securities Exchange, NASDAQ Options Market, NASDAQ OMX PHLX, NYSE Amex, NYSE Arca, and The Options Clearing Corporation (June 22, 2009); Letter to Elizabeth Murphy, Secretary, SEC from Boston Options Exchange, Chicago Board Options Exchange, International Securities Exchange, NASDAQ Options Market, NASDAQ OMX PHLX, NYSE Amex, NYSE Arca, and The Options Clearing Corporation (Sept. 22, 2009).

9 *See* http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm.

price test is re-imposed. Given that the Commission is already considering related rulemaking and the FAQs were adopted without the benefit of industry input or Commission guidance, NASDAQ OMX urges the Commission to either clarify the new FAQ requirements or seek comments regarding the appropriate application of this policy.

Conclusion

NASDAQ OMX urges the Commission to ensure that sufficient empirical evidence exists to support imposing additional restrictions on short selling. It is critical to protect investors and restore their confidence that U.S. capital markets are fair and well regulated. In the past, the Commission has promoted these goals by first identifying empirical evidence of a problem and then crafting incremental regulatory changes to address that problem. This incremental approach has significantly reduced delivery failures and abusive naked short selling along with it.

If the Commission determines that sufficient empirical evidence exists in the record before it, NASDAQ OMX urges the Commission to adopt a Circuit Breaker as the next incremental measure to address abusive short selling. The Circuit Breaker is highly likely to address the identified problem, relatively easy to implement, and unlikely to excessively undermine liquidity and price discovery. In contrast, price tests that are "always on" will negatively impact not only abusive short selling but also short selling that contributes to the overall market by providing valuable liquidity and price discovery. It is unlikely that a price test will be easier or faster to implement than a Circuit Breaker like those that have been successfully implemented in many different markets for many years.

Respectfully submitted,

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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