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Goldman Sachs

June 19, 2009

Elizabeth Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Proposed Measures to Restrict Short Selling – File No. S7-08-09

Dear Ms. Murphy:

Goldman, Sachs & Co. and its affiliates ("Goldman Sachs") appreciate the opportunity to comment on the proposal by the Securities and Exchange Commission ("Commission" or "SEC") to amend Regulation SHO under the Securities Exchange Act of 1934, as amended ("Exchange Act") to implement price restrictions on short selling.[1] Specifically, the SEC has proposed five alternative short sale restrictions that the Commission believes might help promote market stability and restore investor confidence – including price tests that would apply on a permanent, market-wide basis and so-called circuit breakers that would apply on a temporary basis and only to a particular security experiencing a severe price decline. The Proposing Release also discusses and seeks comment on other potential alternatives to address concerns about abusive short selling.

In light of recent market developments, we understand the Commission's desire to re-examine whether further limitations on short selling are necessary and commend the Commission for its extensive efforts to solicit a broad and comprehensive range of views and analysis to ensure that there is a full and balanced dialogue on this important and complex issue. After carefully weighing the costs and benefits, including the impact of other steps that the SEC has taken over the past year (*e.g.,* the enhanced delivery and mandatory close-out requirements of Rule 204T of Regulation SHO), we do not think the available evidence supports a need for short sale price restrictions. We also are concerned about the potential unintended and adverse consequences that short sale price restrictions might have on market efficiency and liquidity provision, which will adversely affect investors and our global competitiveness. Nonetheless, to the extent that the Commission decides to take action, we believe that the best approach would be a circuit breaker rule that is similar to the Commission's proposed circuit breaker with modified

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1 Exchange Act Release No. 59748 (Apr. 10, 2009), 74 Fed. Reg. 18042 (Apr. 20, 2009) (the "Proposing Release").

uptick rule,[2] and that leverages to the extent possible the infrastructure that has already been developed for purposes of compliance with Regulation NMS under the Exchange Act.

Our comments below represent general principles that we believe should guide the Commission. Ultimately, however, it is not possible to separate the decisions concerning the type of short sale price restriction adopted, the details of how it should be implemented, and the necessary exemptions. Until the SEC commits to a single approach, it will be impossible to present our views on all of the details of implementation. Accordingly, we believe that, if and once the Commission selects a particular alternative, the industry should be provided with a reasonable period of time to comment on the details of that approach, including issues related to implementation and the exemptions that are needed.

I. Background

Goldman Sachs is a global investment banking and brokerage firm that performs a wide range of services, from capital raising to secondary trading to advising clients throughout the world. Goldman Sachs participates in the U.S. and international capital markets in many ways, including as upstairs block positioners, stock, options and ETF market makers, proprietary traders, underwriters, and electronic trading service providers. We bring the perspective of these varied businesses to our consideration of the SEC's proposed short selling restrictions.

Goldman Sachs shares the Commission's interest in ensuring that the U.S. equity markets continue to be deep, liquid and efficient and that investors believe that they will be treated fairly when they participate in these markets. Fundamentally, our ability to serve our clients and meet our obligations as financial intermediaries (in all the capacities described above) is tied directly to the willingness of retail and institutional investors, public companies, and others to participate in the securities markets. Investors will not participate if they fear that there is an excessive risk of manipulation.

A. Historic Market Conditions

The Commission has stated that the proposed rules are motivated by "extreme market conditions" and "the resulting deterioration in investor confidence."[3] In particular, U.S. markets recently experienced severe price declines not seen since the Depression. As noted by the Commission, between July 2007 and March 2009 the Dow Jones Industrial Average lost approximately 50% of its value while the Standard & Poor's 500 Index lost approximately 54% of its value.[4] The stock prices of financial institutions

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2 Our recommended approach would be broadly consistent with the proposals outlined by certain national securities exchanges in March 2009 in response to the Commission's announcement that it would consider ways to address abusive short selling. Letter from National Securities Exchanges to Chairman Mary Schapiro, U.S. Securities and Exchange Commission (March 24, 2009).

3 Proposing Release at 18043.

4 Proposing Release at 18048.

were hardest hit, resulting in the failure of several commercial banks and the bankruptcy of a major broker-dealer. Global securities markets experienced similar volatility and downward price pressure. Throughout this period, U.S. investors expressed concern that unrestricted short selling may have been exacerbating the decline in prices. In light of these developments and their adverse impact on investor confidence, we understand that reexamination of short selling regulation is timely and appropriate

B. Short Selling and Its Market Impact

While we realize that these are pressing concerns, it is essential that any rulemaking in this area be undertaken only after a "thoughtful, deliberative process."[5] As the SEC has acknowledged, short selling provides important benefits to the markets, including enhanced liquidity and pricing efficiency.[6] Short selling is a legitimate trading strategy that adds to the selling interest available to buyers. Market professionals often engage in short selling to offset temporary imbalances between supply and demand, which contributes to the maintenance of fair and orderly markets. Short sellers also add liquidity to the market when they purchase shares to cover their short sales.

In addition to enhancing liquidity, short selling helps establish appropriate prices for securities.[7] In particular, short sellers add to pricing efficiency by signaling to the market that they believe a security is overvalued and that the price of the security will fall. Arbitrageurs can also use short sales to profit from temporary price disparities between a security and a related instrument, thereby helping to restore equilibrium between the markets.

By contrast, rules that increase the costs of legitimate short selling lessen these benefits. As the Commission itself has recognized, inappropriate short sale price restrictions introduce inefficiencies into the markets, resulting in decreased liquidity, less quote depth, and wider spreads.[8] Restrictions on short selling also can interfere with price discovery (because negative views about a company's fundamentals are not reflected in the market) and limit the ability of short sellers to combat artificially <u>high</u> prices. These types of market distortions adversely impact the price, speed, and costs of execution afforded U.S. investors.

Of course, while much of the discussion about short selling has focused on secondary trading, the robustness of those markets also affects the capital formation process. For example, due to the Short Sale Ban in fall 2008, many holders of convertible securities issued by financial companies were unable to actively manage their risk by selling the issuer's common stock short (a strategy known as convertible arbitrage). This not only caused liquidity to dry up in the secondary market but also

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5 Chairman Mary Schapiro, U.S. Securities and Exchange Commission, Opening Statement Before the Commission Open Meeting (April 8, 2009).

6 Proposing Release at 18044.

7 Proposing Release at 18044.

8 Proposing Release at 18044.

resulted in a substantial decrease in investor appetite for convertible securities and thus limited the ability of companies to raise capital.[9]

For these reasons, unless the Commission proceeds with the utmost care, its efforts could fail to achieve their intended purpose or could even have the opposite effect – *i.e.*, eroding investor confidence and weakening the global competitiveness of the U.S. capital markets. As the Commission appreciates, the world's capital markets have become highly integrated as a result of improved technology and connectivity and the removal of barriers to the free flow of capital.[10] As a global firm, we are concerned that, if the U.S. regulatory framework is perceived as being overly restrictive, U.S. markets will become less efficient and therefore less attractive for investors and issuing companies. Such a development, in our view, would be particularly unfortunate at a time when increasing the competitiveness of the U.S. capital markets is so crucial to solving today's global financial crisis.

C. Is There a Need for Additional Short Sale Restrictions?

After considering the costs and benefits associated with the current proposals, we do not believe that further action to restrict short selling is warranted or will serve the SEC's ultimate goal of restoring investor confidence in our markets. Over the past year, the Commission has devoted substantial attention to curbing potentially abusive short selling and increasing the transparency of short selling activities to regulators. We believe that the steps taken by the Commission to date have been effective.

Rule 204T, which imposes enhanced delivery requirements on sales of all equity securities, has been effective in reducing large and persistent fails to deliver and provides "a powerful disincentive to those who might otherwise engage in potentially 'naked' short selling."[11] At the same time that it implemented Rule 204T, the Commission also eliminated the options market maker exception from the close-out requirement in Rule 203(b)(3) of Regulation SHO.[12] These rule changes, taken together, have brought additional discipline to the clearance and settlement process. For example, the Commission's Office of Economic Analysis ("OEA") estimates that failures to deliver declined by 56.6% (based on the average daily number of shares failing for all securities),

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9 Tom Lauricella, Short-Sale Ban Wallops Convertible-Bond Market, Wall St. J. (Sept. 26, 2008), at C2; Darwin Choi, *et al,* Convertible Bond Arbitrageurs as Suppliers of Capital (March 4, 2009).

10 *See, e.g.,* Chairman Christopher Cox, U.S. Securities and Exchange Commission, Re-Thinking Regulation in the Era of Global Securities Markets (Jan. 24, 2007).

11 Exchange Act Release No. 58773 (October 14, 2008), 73 Fed. Reg. 61706, 61707 (October 17, 2008) (adopting Rule 204T as an interim final temporary rule). On September 17, 2008, the Commission issued an emergency order adding and making immediately effective temporary Rule 204T. Exchange Act Release No. 58572 (September 17, 2008), 73 Fed. Reg. 54875 ("September Emergency Order").

12 September Emergency Order (adopting and making immediately effective amendments to Rule 203(b)(3) to eliminate the options market maker exception); Exchange Act Release No. 58775 (October 14, 2008), 73 Fed. Reg. 61690 (October 17, 2008) (approving the amendments on a permanent basis). The other major exception from the close-out requirement, the grandfather provision, was eliminated as of October 15, 2007. Exchange Act Release No. 56212 (Aug. 7, 2007), 72 Fed. Reg. 45544 (Aug. 14, 2007).

following implementation of Rule 204T and elimination of the options market maker exemption.[13] Goldman Sachs' Securities Lending group has observed a similar, significant decline in fails. Finally, based on OEA's analysis, the average daily number of securities on the threshold list decreased by 77.5% from the pre-rule period to the post-rule period.[14]

The Commission also recently addressed the problem of potentially manipulative short selling in connection with public offerings.[15] By amending Rule 105 of Regulation M to make it unlawful for a person to sell short an offered security during the applicable Regulation M restricted period and then to purchase the same security from an underwriter or selling group member, the Commission removed some of the judgment and subjectivity that impeded effectiveness of prior versions of this short sale anti-manipulation rule.

Similarly, while the SEC has the authority to police short selling abuses pursuant to Rule 10b-5 of the Exchange Act, the Commission recently added to its tools in this area by adopting a new antifraud rule. Adopted in 2008, Rule 10b-21 is aimed at short sellers, including broker-dealers acting for their own accounts, who deceive specified persons, such as a broker or dealer, about their intention or ability to deliver securities in time for settlement and that fail to deliver securities by settlement date.[16]

The Commission also enhanced its access to information regarding short sale positions held by institutional investment managers through the adoption of Regulation SH.[17] The rule requires certain institutional investment managers that exercise investment discretion with respect to accounts holding Section 13(f) securities to file a nonpublic Form SH on a weekly basis if they have effected short sales with respect to a Section 13(f) security. As a result, the Commission has unprecedented access to short sale position information of large institutional holders.

Perhaps most importantly, it is not clear from the empirical evidence that short selling was responsible for the extreme market conditions recently experienced by the capital markets. For example, data reviewed by OEA for three weeks in September 2008 – an extremely volatile period for the market – suggests that long selling, not short selling, contributed to downward selling pressure last year.[18] Specifically, the OEA study sought

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13 Office of Economic Analysis, U.S. Securities and Exchange Commission, *Impact of Recent SHO Rule Changes on Fails to Deliver* (Apr. 16, 2009). OEA evaluated the impact of these rule changes by comparing data for the period from January 1, 2008 to September 22, 2008 (pre-rule period) to data for the period from September 23, 2008 to March 31, 2009 (post-rule period).

14 *Id.*

15 Exchange Act Release No. 56206 (August 6, 2007), 72 Fed. Reg. 45094 (August 10, 2007).

16 Exchange Act Release No. 58774 (October 14, 2008), 73 Fed. Reg. 61666 (October 17, 2008).

17 Exchange Act Release No. 58785 (October 15, 2008), 73 Fed. Reg. 61678 (October 17, 2008).

18 Memorandum from Daniel Aromi and Cecilia Caglio, Office of Economic Analysis, to Chairman Christopher Cox, U.S. Securities and Exchange Commission, *Analysis of Short Selling Activity During the First Weeks of September 2008* (Dec. 16, 2008).

to establish whether, at an intraday level, there was an association between measures of short selling activity and stock returns and, in particular, whether periods of negative returns were associated with unusually high short selling activity. OEA's findings did not support the notion that extreme negative returns were the result of short selling activity. Instead, on average, short sale volume as a fraction of total volume was higher for periods of positive returns than for periods of negative returns. Long sellers were determined to engage in more aggressive pricing, on average, than short sellers. Most notably, during periods of extreme negative returns, the sell pressure was more intense for long sales – in other words, short sales put less pressure on prices than other sales during periods of extreme negative returns.[19]

The most recent OEA findings are consistent with prior studies on short sale price restrictions. For example, in connection with the Commission's pilot program to examine the efficacy of price tests on short selling in 2005 to 2007, OEA concluded that price restrictions constituted an economically relevant constraint on short selling but that removal of price restrictions for the pilot stocks had not, on balance, had a deleterious effect on market quality or liquidity.[20] OEA also concluded, among other things, that: (1) the pilot program had no impact on the level of short interest in the listed or Nasdaq market, (2) the pilot had no impact on the level of trading in the options market (suggesting that market participants were not using options to avoid the tick test or NASD bid test), (3) the pilot was associated with reduced quote depth, (4) the pilot did not appear to have any significant effect on daily volatility, and (5) there was no evidence of so-called "bear raids" associated with the pilot program.[21] In addition, four privately conducted studies similarly supported removal of short sale price restrictions.[22] Based, in part, on this assessment, the Commission determined to repeal Rule 10a-1 and prohibit self-regulatory organizations from having price-based short sale restrictions.

More recently, the majority of academicians and economists participating in the Commission's 2009 roundtable on short selling thought that short sellers benefit the market and that the Commission should focus on other factors to explain the market events of last fall.[23] Some expressed the view that it was coincidence that the market fell after Rule 10a-1 was repealed, and urged the SEC to adopt some type of a "shock absorber" for the markets but also to look beyond short selling to stem excessive intraday volatility.

In sum, although we are supportive the Commission's goal of restoring investor confidence, we do not believe that the imposition of short sale price restrictions would, in

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19 *Id.*

20 Office of Economic Analysis, U.S. Securities and Exchange Commission, *Economic Analysis of the Short Sale Price Restrictions under the Regulation SHO Pilot* (Feb. 6, 2007), at 56.

21 *Id.* at 55-56.

22 *Id.* at 85-89.

23 An unofficial copy of the roundtable transcript is available at: http://www.sec.gov/spotlight/shortsales/roundtable050509/shortsalesroundtable050509-transcript.pdf

fact, achieve this goal over the long term. The adoption of Rule 204T of Regulation SHO has been very effective to eliminate potential short selling abuses. By tightening the rules governing delivery, the Commission has appropriately focused on the clearance and settlement process, which is where symptoms of abusive short selling are most likely to appear. Moreover, the new Form SH disclosure enhances transparency of short selling activity and, thus, the SEC's ability to detect potential misconduct. The marginal benefit of additional short sale restrictions over the measures already taken by the Commission does not outweigh the potential loss of liquidity and costs to investors in the form of wider bid-offer spreads. We therefore encourage the Commission to conclude that the adoption of new short sale price restrictions is unnecessary and would be damaging to market efficiency and liquidity.

If, however, the SEC concludes that action is necessary, we believe that any short sale price test that is adopted must be narrowly targeted so as to avoid adversely impacting short selling activity that is neither harmful to the markets nor manipulative. Accordingly, we favor a test that is triggered in periods when a particular security is most vulnerable to manipulative short selling and that is adaptable to the realities of today's equity market structure.

II. Goldman Sachs' Recommended Approach

As the Commission must appreciate, it is not feasible for market participants to comment in detail on all five of the alternatives set forth in the Proposing Release. Each alternative would present unique challenges in terms of implementation, and different types of short sale price restrictions would require different exemptions. In our view, the terms of a price test, the means of implementation, and the appropriate exemptions are part of a single integrated package. For this reason, we urge the SEC to provide the industry with a reasonable period of time to comment on the details of any rule that it intends to adopt.

Turning to the substance, we recognize that some members of the public associate the recent price declines and volatility in the U.S. equity markets with the removal of Rule 10a-1 and are advocating that the Commission restore the so-called "tick test." There have also been calls from Congress for the tick test to be reinstated.[24] We first discuss below why an uptick rule would not be workable in today's markets. We then share our views regarding the alternatives proposed, and the questions raised, by the SEC in the Proposing Release.

A. An Uptick Rule Is Ill-Suited to Today's Markets

Goldman Sachs strongly believes that reinstating an uptick rule would be the least effective and most harmful outcome for the U.S. equity markets. Rule 10a-1 was

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[24] To require the Securities and Exchange Commission to reinstate the uptick rule and effectively regulate abusive short selling activities, S. 605, 111th Cong. (2009); To require the Securities and Exchange Commission to reinstate the uptick rule on short sales of securities, H.R. 302, 111th Cong. (2009); Stock Market Recovery Act of 2009, H.R. 1406, 111th Cong. (2009).

implemented at a time when most trading of any given exchange-listed security occurred manually on the floor of the exchange where the issuer was primarily listed. The New York Stock Exchange ("NYSE") and American Stock Exchange – both of which historically used a single specialist to manage an agency auction market – enforced Rule 10a-1's prohibitions by reference to the last sale price on their own respective trading floors (not market-wide). The manual execution and sequential reporting of trades in a security by the specialist on the exchange handling the vast majority of the volume in that security presented perhaps the best case for application of a tick test.

Our markets have changed significantly in the ensuing decades and scarcely resemble the markets at the time Rule 10a-1 was adopted. OTC trading of exchange-listed securities is ubiquitous, and there are few, if any, markets for NMS stocks that continue to use a single specialist model to trade securities. Instead, today's markets – including the NYSE – are characterized by multiple dealers competing for order flow for any given security. While this dispersion of trading within each market center and among various competing market centers undoubtedly has advantages for investors, the decentralization of order flow makes the sequential reporting of trades that would be necessary for a truly effective market-wide tick test more difficult to achieve.

The Commission itself has acknowledged certain inefficiencies with the tick test, including, as noted above, the fact that "last sale price information is published to the markets in reporting rather than trade sequence."[25] Due to firm system latencies, not all broker-dealers received consolidated last sale information simultaneously. The movement to decimal pricing earlier this decade and the trading of many NMS stocks in penny increments, which makes an uptick less meaningful and easier to achieve for short selling purposes, further undercut the effectiveness of the tick test. Finally, the lack of uniform short sale price restrictions among markets created opportunities for regulatory arbitrage. In our experience, the tick test was susceptible to circumvention and/or gaming due to these trade sequencing and other operational inefficiencies. For example, in a penny trading environment, it was relatively easy for someone intent on short selling to facilitate such trading by routing a small buy order to a market for execution and reporting the trade at a price above the last sale price.

Moreover, Rule 10a-1 was not well suited to contemporary trading strategies and systems, as evidenced by the numerous instances in which the Commission or its staff granted relief from the rule's prohibitions. For example, the Commission provided exemptions for various systems designed to achieve volume weighted average price trades,[26] as well as to alternative trading systems engaged in periodic crossing of orders at

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25 Proposing Release at 18049.

26 *See e.g.* letter from Larry E. Bergmann, Senior Associate Director, Division of Market Regulation, SEC, to Edith Hallahan, Counsel, Phlx, dated March 24, 1999; letter from Larry E. Bergmann, Senior Associate Director, Division of Market Regulation, SEC, to Soo J. Yim, Wilmer, Cutler & Pickering, dated December 7, 2000; letter from James Brigagliano, Assistant Director, Division of Market Regulation, SEC, to Andre E. Owens, Schiff Hardin & Waite, dated March 30, 2001; letter from James Brigagliano, Assistant Director, Division of Market Regulation, SEC, to Sam Scott Miller, Esq., Orrick, Herrington & Sutcliffe LLP, dated May 12, 2001; letter from James Brigagliano, Assistant Director, Division of Market Regulation, SEC, to William W. Uchimoto, Esq., Vie Institutional Services, dated February 12, 2003.

prices derived from the national best bid and offer.[27] The Commission also granted exemptions from Rule 10a-1 for certain transactions involving exchange-traded funds ("ETFs"),[28] and broker-dealers engaging in riskless principal transactions to facilitate customer buy or long sale orders.[29]

The problems that existed under the original tick test would only be exacerbated in today's fast-moving, automated trading environment. The structure of the U.S. equity markets has fundamentally changed since the adoption of Regulation NMS in 2005. Markets are faster and better linked than ever before. There are countless trading centers (exchanges, alternative trading systems, market makers, etc.), all of which trade NMS stocks with execution speeds measured in fractions of a second. In addition, market participants now obtain market data from numerous sources other than the processors of the joint industry plans. Trading is highly automated and based on a trading center's obligation to honor the "protected bids" and "protected offers" of other trading centers. Reverting to a last sale based "tick test" not only would be ill-advised for the practical reasons noted above, but would be inconsistent with the path the Commission has blazed for our markets through the adoption of Regulation NMS.[30]

Although a bid test based on "Firm Specific Data" (as defined below) might be viewed as presenting sequencing issues similar to those discussed with respect to consolidated last sale data, the two proposals differ significantly. Fundamentally, we would not expect there to be such wide divergences between Firm Specific bids and bids supplied by the industry plans. Quotes are required to be updated immediately, while trade reports, by rule, are compliant if reported within 90 seconds. Because the time of the trade was reported is de-linked from the time the trade actually was executed, the fact that the reported last sale happens to be higher or lower than the prior last sale is not a reliable indicator of price trends.

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27 *See, e.g.,* letter from Larry E. Bergmann, Senior Associate Director, Division of Market Regulation, SEC, to Andre E. Owens, Schiff Hardin & Waite, dated April 23, 2003 (granting exemptive relief from former Rule 10a–1 for trades executed through an alternative trading system that matches buying and selling interest among institutional investors and broker-dealers at various set times during the day).

28 *See, infra,* note 42.

29 Letter from James A. Brigagliano to Ira Hammerman, Senior Vice President and General Counsel, Securities Industry Association, dated July 18, 2005.

30 These changes in market structure have also made it more difficult to comply with other rules that involve a test based on the last sale price (*e.g.,* Rule 10b-18 under the Exchange Act, which provides issuers with a "safe harbor" from liability for manipulation when they repurchase their common stock in the market in accordance with certain price and other conditions). In addition, several years ago, the NYSE amended its specialist stabilization rules to eliminate the definition of stabilization in terms of the last sale. In its rule filing with the SEC, the NYSE described its then-current tick-based rules as "unworkable and less relevant" in today's environment. Exchange Act Release No. 54860 (December 1, 2006)

B. Recommended Circuit Breaker Rule

The Proposing Release discusses five alternative short sale restrictions – two are price tests that would be permanent and apply market-wide; three are circuit breaker rules that would be temporary and would be triggered for a particular security once certain thresholds have been met. In light of the SEC's other initiatives regarding short selling and the empirical evidence that exists, we believe that any rulemaking in this area should be narrowly tailored to address situations that pose the greatest risk of abusive short selling in a manner that minimizes the potential adverse consequences.

We therefore recommend that, if the Commission decides to take action, it should adopt a circuit breaker, not a permanent, market-wide price test. Once triggered, the SEC's proposed circuit breaker rules would restrict short selling for the remainder of the trading day in specific securities that have experienced a rapid, severe intraday price decline. Market participants could freely engage in short selling in all other circumstances; most notably, there would be no restrictions in advancing markets or in down-trending markets where the declines are not severe. For these reasons, we believe a circuit breaker would be less disruptive to the smooth functioning of the markets as a whole (in terms of liquidity, pricing efficiency, volatility, etc.) than a permanent price test.

In terms of the alternatives presented in the Proposing Release, Goldman Sachs believes that the best option would be a simplified version of the Commission's proposed circuit breaker with modified uptick rule. Our views on this issue, and other issues related to the mechanics of a circuit breaker, are set forth below.

1. Trigger for Circuit Breaker

Under all three of the SEC's proposed circuit breaker rules, a circuit breaker would be triggered by a 10% intraday decline in the price of a particular equity security. We are concerned that there could be situations in which a 10% threshold would not strike an appropriate balance between normal trading activity, on the one hand, and severe price declines that might indicate the need for price restrictions to prevent manipulative short selling, on the other hand. Instead, we would recommend a range from a 10% decline to a 20% decline with securities assigned to tiers based on share price, average daily trading volume, market capitalization, stock volatility, or a combination of those factors.

We believe that the decline for any circuit breaker proposal should be measured from the current day's opening price on the primary market, rather than the prior day's closing price as the SEC has proposed. If, for example, a company releases significant news after the close, that information will be reflected in the opening price of the security. The percentage change from the opening price would therefore be a better benchmark to identify when a security might be trading outside its natural range.

We would recommend that the rule be in effect during regular trading hours as defined under Regulation NMS. Once the circuit breaker is triggered for a particular security, a trading halt should be declared, and, after the market is re-opened, the security should be subject to price restrictions for the remainder of the trading day. If halting trading when a security's threshold is reached proves to be impracticable, we suggest as an alternative that price restrictions only be applied to new short sale orders (*i.e.*, execution of any permissibly priced orders submitted prior to the circuit breaker being triggered would not be restricted).

2. **Effect of a Circuit Breaker Being Triggered**

To minimize disruption to trading and facilitate implementation of any short sale price restriction adopted, it will be important that trading centers and broker-dealers be able to leverage their existing technology. In particular, firms have invested significant resources in developing systems to comply with Regulation NMS. Such systems identify protected quotations throughout the market, determine where orders should be routed consistent with the Order Protection Rule ("OPR"),[31] receive and execute inter-market sweep orders and other orders routed by other trading centers, help identify transactions exempt from the OPR, detect latencies in data, obtain "snapshots" of relevant market conditions, and are used to conduct regular and periodic surveillance. Notably, at the time that Regulation NMS was being implemented, the SEC staff indicated that firms need not program their systems for compliance with a short sale price test because, in all likelihood, the Commission would eliminate a price test at the completion of the Regulation SHO Pilot Program.[32] Therefore, if the Commission determines that a price test is necessary, the Commission should weigh the impact of its proposals in terms of the devotion of firm resources and the time required to prepare for implementation and should closely assess whether its goals could be met through the use of existing firm technology.

We believe a prohibition on the execution or display of short sale orders at or below the current national best bid (assuming it is a protected bid) would be easier to implement than the concept of a "down-bid price" included in the proposed circuit breaker with modified uptick rule.[33] Such a test would be consistent with OPR systems currently in place. In contrast, the Commission's proposed approach would require trading centers and broker-dealers to establish additional policies, procedures, systems and processes with respect to calculating whether the current national best bid is an up-bid or down-bid from the last differently priced national best bid.

However, if the trigger for the circuit breaker is set a significantly lower level than the 10% to 20% threshold that we propose (depending on the trading characteristics

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31 17 C.F.R. §240.611.

32 Proposing Release at 18062, n.208.

33 As proposed, a "down-bid price" would be defined as "a price that is less than the current national best bid or, if the last differently priced national best bid was greater than the current national best bid, a price that is less than or equal to the current national best bid."

of a security), the rule would operate as a significantly greater restraint on otherwise legitimate and beneficial market activity. In that case, we believe a more flexible price test would be necessary and would support the Commission's proposed approach, which would permit short selling at the bid in certain instances involving "zero plus bids".

Furthermore we urge the Commission to issue clear guidance that permits trading centers and broker-dealers to use vendor or other internal market data ("Firm Specific Data"), rather than consolidated data supplied by the industry plans, to determine whether a short sale order is permissibly priced. As the Commission recognized in the context of Regulation NMS, investors benefit from the ability of firms to use all available sources of market data in making trading decisions.[34] We expect that it will be necessary to develop order types – similar to ISOs in the OPR context – that permit firms to route and execute permissible short sales based on Firm Specific Data. We believe that a Firm's compliance with any short sale price restriction should be based on the reasonableness of its data handling policies and procedures (as is the case for Regulation NMS). In this regard, it also will be important for the Commission to address the maintenance of Firm Specific Data.[35]

C. Exemptions

As proposed, each of the Commission's alternative short sale rules would include a range of exemptions (which would vary, to some degree, depending on the proposal). We support these exemptions.

There are two areas, however, where it is essential that the Commission expand its proposed exemptions to avoid disrupting the orderly functioning of the U.S. equity markets and increasing costs for investors. In particular, we strongly believe that any new short sale price restrictions must include a general market maker exemption,[36] and that the transactional exemptions should cover a wider variety of trading strategies that are beneficial to investors and pose little risk of abuse.

1. Market Maker Exemption

The Commission on numerous occasions has recognized the critical role that market makers play in providing liquidity to the markets and has accorded them regulatory treatment commensurate with that role. For example, market makers are exempt from Regulation SHO's uniform locate requirement. The SEC concluded that such an exemption was necessary to enable market makers to "facilitate customer orders in a fast moving market without possible delays associated with complying with the

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[34] *See* FAQs 6.01 and 6.02, Responses to Frequently Asked Questions Concerning Rule 611 and Rule 610 of Regulation NMS (April 4, 2008).

[35] *See* FAQ 6.03, Responses to Frequently Asked Questions Concerning Rule 611 and Rule 610 of Regulation NMS (April 4, 2008).

[36] Currently only the SEC's proposed circuit breaker with trading halt rule includes a general market maker exception.

proposed 'locate' rule."[37] For similar reasons, market makers were exempted from last fall's Short Sale Ban,[38] and are provided limited relief from the hard T+3 close-out requirements under Rule 204T.[39] We believe that market makers must be exempt from any new short sale price restrictions to allow them to continue to provide liquidity and to adjust and hedge their positions quickly and efficiently. If market participants are not certain of their ability to manage risk, they will be less willing to perform these vital functions.

Given the realities of today's marketplace, such an exemption should apply to the full range of liquidity providers that have obligations under SRO rules or that hold themselves out as willing to commit capital to meet the needs of their clients and counterparties. This would include: exchange-based market makers (including options and ETF market makers); over-the-counter market makers and derivatives dealers; "Authorized Participants" engaged in creations and redemptions of ETFs; and upstairs customer facilitation desks that meet a certain threshold (*i.e.*, a minimum amount of capital commitment/block trading over a specified period of time).[40]

We appreciate the Commission's concerns that a general market maker exemption could undermine the goals of its proposed restrictions. To the extent that the exemption is limited to shorts sales effected as part of bona fide market making in the securities subject to restrictions and bona fide market making and hedging activity in connection with bona fide market making in related instruments, we believe the benefits of such trading activity clearly outweigh the costs. Moreover, Rule 204T applies to fails attributable to bona fide market making, which would act as a constraint on potential misuse of a market maker exemption.

2. Exemptions for Certain Transactions

In addition, there are certain transactions that the Commission should exempt from any new short sale restrictions because the transactions, by their terms, do not pose the risk of the type of manipulative conduct such restrictions are designed to address. For example, a number of the exemptions to the OPR also would appear appropriate as exemptions to a circuit breaker rule or other price restriction. Such transactions would include:

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37 Exchange Act Release No. 48709 (Oct. 28, 2003), 68 Fed. Reg. 62972, 62977 (November 6, 2003).

38 Exchange Act Release No. 58592 (Sept. 18, 2008), 73 Fed. Reg. 55169 (Sept. 24, 2008); Exchange Act Release No. 58611 (Sept. 21, 2008), 73 Fed. Reg. 55556 (Sept. 25, 2008).

39 Securities Exchange Act Release No. 58773 (October 14, 2008), 73 Fed. Reg. 61706 (Oct. 17, 2008).

40 We would also recommend that the SEC take this opportunity to update the definition of "market maker" to include market participants that have obligations to customers and are integral sources of liquidity in today's markets.

- The execution or display of orders marked as priced consistent with the circuit breaker rule when routed to other trading centers for execution or display;
- The execution or display of orders at a price that exceeds the bid price displayed during the prior one second period, to address the likelihood of rapidly changing quotations ("flickering bid" exemption);
- VWAP orders and other "benchmark trades" involving the execution of an order at a price that was not based, directly or indirectly, on the quoted price of an NMS stock at the time of execution and for which the material terms were not available at the time the commitment to execute the order was made;
- Qualified contingent trades, as defined in connection with Regulation NMS;[41]
- Error correction trades, also as defined in Regulation NMS; and
- Opening, re-opening, and closing transactions.

In each of these instances, the pricing of the security either must be consistent with the short sale price test when displayed or executed or not tied to current market conditions, thereby significantly reducing manipulation concerns. Appropriate trade reporting modifiers should be developed to identify trades that qualify for an exemption.

D. Assessing Compliance with Short Sale Price Restrictions

As part of its circuit breaker with modified uptick rule, the Commission has proposed that a firm's compliance with the rule should be assessed based on its implementation of reasonable written policies and procedures designed to prevent the display or execution of short sales at impermissible prices. In this regard, we note that a short sale price test is, in many ways, similar to the OPR from a compliance perspective. Like the OPR, new short sale restrictions will require extensive programming and systems monitoring. Similarly, firms will execute countless short sale orders in rapidly changing markets on any given day.

Regulation NMS illustrates the SEC's recognition of the difficulty of achieving absolute compliance with technical trading rules. Instead the Commission provided, firms with extensive guidance as to factors material to developing reasonable policies and procedures to promote compliance. We generally believe that, for technical rules like the OPR or a short sale price test, an approach that focuses on reasonable policies and procedures can result in more effective regulation than an approach based on examination for and scrutiny of isolated instances of non-compliance. Therefore, we agree with the policies and procedures approach included in the proposed circuit breaker with modified uptick rule and believe that it should apply to any price test the Commission ultimately may determine to adopt. As in the Regulation NMS context, we encourage the Commission to engage in a dialogue with the industry to help firms develop appropriate policies and procedures with respect to any new price test.

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41 FAQ 3.12, Responses to Frequently Asked Questions Concerning Rule 611 and Rule 610 of Regulation NMS (April 4, 2008); Exchange Act Release No. 54389 (August 31, 2006), 71 Fed. Reg. 52829 (September 7, 2006).

III. Responses to SEC's Specific Questions

The following summarizes our responses to some of the key questions raised by the SEC in the Proposing Release.

- We support a circuit breaker rule that, once triggered, would permit the continued display and execution of short sale orders on a passive basis, rather than a rule that would result in a ban on further short selling.

- We support a circuit breaker rule that would result in a prohibition on "hitting" the current national best bid. However, absent a sufficiently flexible trigger level (along the lines we discuss below), we believe the Commission's proposed modified uptick rule is the next best alternative.

- We believe that circuit breaker triggers should be measured from the opening price and that the threshold should be a decline of between 10% and 20% depending on a security's share price, average daily trading volume, market capitalization and/or stock volatility.

- Once the circuit breaker is triggered for a particular security, the price restrictions should be in effect for that security until the end of the relevant trading day (*i.e.*, until the consolidated tape closes), not for multiple days. Conversely, we would not support restrictions that would last for a matter of hours. In our view, frequent changes in the status of a security would create more disruption.

- Exchanges should be required to declare a trading halt in a security subject to a circuit breaker and then re-open the market. Thereafter, a trading center could reject any short sale order (other than an order marked "short exempt") that is impermissibly priced based on the trading center's own data. Alternatively, if a trading halt is not practical, the price test should be applied to new short sale orders only.

- Broker-dealers should be able to rely on their own internal data and send a short sale order with a flag indicating that the order was permissibly priced at the time it was sent (similar to the intermarket sweep order exception under Regulation NMS). The trading center receiving the order could execute or display it without regard to the trading center's own data or any other external data.

- Certain types of securities (*e.g.*, broad-based ETFs, ADRs) should be exempt from any restrictions on short selling because their prices are largely determined by factors other than the security's current protected quotations. Such an exemption would be consistent with the relief that the Commission granted under Rule 10a-1 for short sales of ETFs that met certain requirements relating to the composition of the ETF.

Because the price of ETFs rises or falls based on changes in the value of the component securities, ETFs were viewed as less susceptible to manipulation.[42]

- Given that the vast majority of trades settle on time, the costs of imposing a pre-borrow requirement for every short sale would far outweigh the benefits, by dramatically impairing liquidity provision and widening bid-offer spreads. OEA's analysis of the impact of the SEC's July 2008 emergency order found that the securities subject to the pre-borrow requirement experienced "[l]arge and statistically significant" decreases in short selling volume and "dramatic, but temporary, initial increases" in stock lending rates (although fails did decrease and other measures showed no change). OEA cautioned that "a similar requirement imposed on smaller, more illiquid, or hard-to-borrow stocks might cause a significantly larger disruption to short selling and to liquidity."[43]

IV. Conclusion

Goldman Sachs appreciates the Commission's actions in advancing the important discussion of whether additional restrictions on short selling are necessary, particularly in light of recent volatile market conditions. While we share the Commission's interest in restoring investor confidence, we do not think that the available evidence demonstrates that short selling caused last fall's severe price declines or supports the need for new short sale price restrictions. In our view, the other measures implemented by the Commission over the past year (most notably, Rule 204T) have been very effective at preventing potential short selling abuses, and any marginal benefit from additional regulation would not outweigh the costs. We encourage the Commission to conclude that the adoption of new short sale price restrictions is unnecessary and would be damaging to market efficiency and liquidity.

If, however, the SEC decides to taken action, we believe that any short sale price test that is adopted must be narrowly targeted so as to avoid adversely affecting legitimate and beneficial short selling activity. We strongly believe that reinstating an uptick rule would be the least effective and most harmful outcome for the U.S. equity markets. In our view, the best approach would be a circuit breaker rule that is similar to the Commission's proposed circuit breaker with modified uptick rule.

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42 *See, e.g.,* letter from Racquel L. Russell, Esq., Branch Chief, Office of Trading Practices and Processing, Division of Market Regulation, to George T. Simon, Esq., Foley & Lardner LLP (June 21, 2006); letter from James A. Brigagliano, Assistant Director, Division of Market Regulation, SEC, to Claire P. McGrath, Vice President and Special Counsel, American Stock Exchange (August 17, 2001); letter from James A. Brigagliano, Assistant Director, Division of Market Regulation, SEC, to James F. Duffy, Executive Vice President and General Counsel, American Stock Exchange, dated March 3, 1999 (regarding Nasdaq-100 Trust, Series 1).

43 Office of Economic Analysis, U.S. Securities and Exchange Commission, *Analysis of the July Emergency Order Requiring a Pre-Borrow on Short Sales* (Jan. 14, 2009) at 1-2.

If and once the Commission selects a particular alternative, the industry should be provided with a reasonable period of time to comment. The decisions concerning the type of short sale price restriction adopted, the details of how that restriction will be implemented, and the necessary exemptions are inextricably linked. For that reason, until the SEC commits to a single approach, it is not possible to present our views on the details of all possible permutations of the alternatives presented in the Proposing Release.

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We look forward to working with the Commission on this important issue. Please feel free to contact me with any questions that you may have on our comments.

Very truly yours,

Paul M. Russo

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