October 9, 2009

Honorable Mary L. Schapiro
Chairman
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

RE: Responses to Frequently Asked Questions Concerning Regulation SHO, as recently amended on August 28, 2009, to add new FAQs 2.4 and 2.5

Dear Chairman Schapiro,

BATS Exchange, Inc. ("BATS") is writing in connection with recent amendments the Staff of the Securities and Exchange Commission's ("SEC" or "Commission") Division of Trading and Markets ("Division Staff") made to its on-line publication, *Responses to Frequently Asked Questions Concerning Regulation SHO* ("FAQs"). In particular, on August 28, 2009, the Division Staff added two new items to the FAQs, FAQ 2.4 and FAQ 2.5. As explained herein, in both FAQs, the Division Staff articulates a view of a broker-dealer's obligations under Regulation SHO that we believe dramatically differs from that previously understood by many industry participants. In doing so, the Division Staff is taking positions that impose new, substantive obligations on the industry, and which many industry participants have argued are not practical and could have unintended and detrimental market structure consequences.

Although the FAQs themselves are Division Staff positions that do not have the force of law, in reality any industry participant failing to follow these FAQs will be at substantial risk of facing a regulatory action by either the SEC or a self regulatory organization ("SRO") for non-compliance. BATS certainly looks to the Division Staff's interpretive statements and FAQs to inform its regulatory program, and BATS is aware that the other SROs do the same. The mere threat of such a regulatory action and the associated costs of defending it are key components to what is an inevitable outcome – the industry as a matter of fact treats Division Staff's interpretative statements and FAQs as though they do have the force of law. Because of this inevitability, when as now the Division Staff articulates a view through an FAQ that appears to represent a significant departure from the industry's prior understanding, purports to create an objective standard that is not apparent from the rule at issue, and could impose substantial and costly compliance obligations on the industry, BATS believes it is necessary and appropriate for the Commission to intervene.

Accordingly, BATS respectfully requests that the Commission instruct the Division Staff to withdraw these FAQs, and if it deems it appropriate, engage in rule-making to determine their consistency with the Exchange Act of 1934 ("Exchange Act").

I. FAQ 2.5

In new FAQ 2.5, Division Staff asks the following question and provides the following answer:

> ***Question: How should a broker-dealer mark an order where the seller is net long 1,000 shares and wants to simultaneously enter multiple orders to sell 1,000 shares each?***
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> Answer: Rule 200(g)(1) of Regulation SHO states that '[a]n order to sell shall be marked 'long' only if the seller is deemed to own the security being sold pursuant to paragraphs (a) through (f) of this section and either: (i) The security to be delivered is in the physical possession or control of the broker or dealer; or (ii) It is reasonably expected that the security will be in the physical possession or control of the broker or dealer no later than the settlement of the transaction.' Further, Rule 200(c) of Regulation SHO provides that a person shall be deemed to own securities only to the extent that he has a net long position in such securities.
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> Thus, *we remind sellers* that where a seller is net long 1,000 shares and simultaneously enters multiple orders to sell 1,000 shares owned, only one such order would constitute a long sale. *After the long sale order is entered to sell the 1,000 shares, it is no longer reasonable to expect that delivery can be made by settlement date on additional orders to sell the same shares.* In addition, under Rule 200(g)(1) of Regulation SHO, a broker-dealer must mark only one order as 'long' and any additional orders as 'short.'

(emphasis added).

As stated in the FAQ, the Division Staff is taking the position under Rule 200(g)(1) of Regulation SHO that if multiple sell orders are sent out that exceed the sender's current long position, the sender can no longer claim that it "reasonably expected" that it would have physical possession or control of the security by settlement date for those pending, unexecuted orders that exceed the current long position and, hence, those orders would need to be marked short.

While at first blush the Division Staff's interpretation may seem reasonable – if a broker-dealer has sent sell orders into the market in excess of its long position it shouldn't have the reasonable expectation required under Regulation SHO – in practice, the Division Staff's position fails to recognize a variety of factors that might warrant a contrary conclusion, is turning the subjective standard of "reasonable expectations" into an absolute objective standard, which appears inconsistent with Regulation SHO, and according to many market participants represents a departure from years of industry understanding.

Historically, certain broker-dealers have interpreted the short sale marking requirements as being driven by their actual position at the time of order entry, without regard to open orders in the marketplace. This position has been unquestioned until now[*] and was explicitly supported by Nasdaq. In 1997, Nasdaq issued Equity Trader Alert 97-38 ("ETA 97-38"), in which it articulated a position that is at odds with the Division Staff's current view and which has become the standard by which firms measure their compliance with short sale marking requirements. In particular, in ETA 97-34, Nasdaq stated the following:

> **Simultaneous entry of Orders into SelectNet and Execution Systems Operated by Other Broker Dealers**
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> In Nasdaq Fax #34, Nasdaq stated that in instances where a Market Maker enters an order into a Nasdaq-sponsored order execution system or an automated execution system sponsored by another broker-dealer that reports trades on behalf of the Market Maker (e.g., SelectNet, an ECN, or a proprietary trading system operated by another broker dealer), compliance with the new ACT reporting requirements may be determined based on the Market Maker's stock position and the status of the inside bid as of the time the order is entered into the automated execution system.
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> The following addresses a frequently asked question concerning this clarification:
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> **Q:** A firm that is long 2,000 shares simultaneously enters four orders to sell into SelectNet for 2,000 shares each. Must one of the four orders be marked long and the rest short or should all four orders be marked long?
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> **A:** *All four orders should be marked long. This is because the firm does not know which of the four orders, if any, will be executed at the time of order entry.*

(emphasis added).

While ETA 97-38 was issued prior to the Commission's adoption of Regulation SHO, it is notable that neither the Regulation SHO proposing or adopting releases contained a discussion of this specific point. In the absence of any mention by the Commission of the issue or that it was countermanding the Nasdaq ETA, and when faced with the need to interpret a subjective standard in Regulation SHO ("reasonable expectations"), it could be argued that it is sensible for industry participants to be informed in that regard by prior relevant statements from an SRO. At a minimum, it is difficult to imagine how the Division Staff could take the position that its interpretation in FAQ 2.5 is clear from the language of Regulation SHO. As such, BATS understands that broker-dealers have generally considered germane to their reasonable expectations the fact that in the above scenario they do not know which, if any, of the open

[*] Although FAQ 2.5 is styled as a "reminder", we have found no prior published guidance or interpretation on this subject consistent with FAQ 2.5.

orders will be executed at the time of order entry. In addition, BATS understands that broker-dealers felt that they had a reasonable basis to believe that they would be in a position to deliver securities (or offset any resultant short position) for any sell order that was executed.

The Division Staff's FAQ 2.5 takes a completely opposite view, suggesting that in the above scenario firms cannot reasonably expect to meet their delivery requirements on settlement date because multiple sell orders are pending in the marketplace. Importantly, in our conversation with the Division Staff it would appear that the Staff is taking the view that the only fact relevant to the subjective determination of a firm's reasonable expectations is the orders to sell it has pending in the marketplace. Thus, according to Division Staff, pending buy orders would not be relevant to the analysis of a broker-dealer's reasonable expectations of meeting its delivery requirements with respect to pending sell orders, nor would the likelihood of execution of any given sell order, the nature of the broker-dealer's business (*e.g.*, a market maker who is equally likely to buy or sell at any moment), or the broker-dealer's prior history of satisfying its delivery requirements under Regulation SHO.

This is directly contrary to the position Division Staff has taken with respect to other "reasonableness" determinations under Regulation SHO. For example, in FAQ 4.1, Division Staff states, "'[r]easonableness' is determined based on the *facts and circumstances* of the particular transaction. What is reasonable in one context may not be reasonable in another context." (Emphasis added).

To the extent the Commission deems it important to place objective criteria around the seemingly subjective reasonable expectation standard contained in Regulation SHO, we believe the Commission should determine through rule-making the appropriateness of the Division Staff's view on the issue. This would give industry participants the ability to articulate those considerations that they believe should be factored into the analysis. For example, many firms act as market makers and send large volumes of orders throughout the day on both sides of the market in sub-second time frames. Many of these orders are cancelled and replaced as the markets move and, while such firms may send tens of thousands of orders to buy and sell representing millions of shares throughout the day, a much smaller number of these orders are ever actually executed and such firms generally end the day with flat positions.

In addition, because these firms are actively trading throughout the day on both sides of the market, they may rarely, if ever, have an actual short position intra-day. However, per the Division Staff's FAQ all or nearly all of such firms' sell orders would be required to be marked short, resulting we suspect in a dramatically distorted increase in short sale reporting. As a market regulator, BATS is concerned that this distorted data will frustrate our surveillance and regulatory efforts associated with other provisions of Regulation SHO. Likewise, as a market center, we are faced with the uncomfortable prospect of publishing short sale data which we know to be misleading.

Given these facts, is it appropriate for the Division Staff to decide that firms cannot have a reasonable expectation of meeting their delivery requirements with respect to pending sell

orders? Or, is it appropriate for firms to consider their overall business practices and experience in determining their reasonable expectations?

The answers to these questions matter because according to some firms making markets across multiple trading venues, the impact of requiring their automated systems to precisely calculate a single position based on pending sell orders in the marketplace at any given point in time rather than on actual changes to that position resulting from executions could have a significant and detrimental impact on their ability to provide liquidity to the market.

In the absence of subjecting this FAQ to the rule-making process, BATS is concerned that some firms may adopt compliance measures that will serve to even further distort the true rate of short selling in the market. For example, BATS has anecdotally heard that some firms are considering complying with the Division Staff's FAQ by placing large sell orders far away from the market each day and then marking all their subsequent sell orders as short for the remainder of the day regardless of their actual position. Using this strategy, the orders would be correctly marked when entered per the Division Staff's FAQ based on a comparison of the firms' opening positions against pending sell orders, however, such conduct in our view would serve to undermine the intent of the marking requirement in Regulation SHO and would yet again present a grossly distorted view of the level of actual short sale activity. As a market regulator, BATS is concerned that the Division Staff's FAQ could make it difficult to prevent firms from engaging in such conduct. Accordingly, BATS believes that the Commission should intervene and instruct Division Staff to withdraw this FAQ pending potential rule-making to determine its consistency with the Exchange Act.

II. FAQ 2.4

In new FAQ 2.4, the Division Staff again took a position that dramatically differs from years of prior industry understanding. The Division Staff asked the following question and provided the following answer:

> ***Question 2.4: How should a broker-dealer mark an order where the seller is net long for only part of the order?***
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> ***Answer:*** A seller may be net long a security but wish to sell additional shares of that security in excess of the seller's net long position. For example, a seller may be net long 500 shares of a security but may wish to sell a total of 600 shares of that security. Under such circumstances, only 500 shares can be sold long, and the remaining 100 shares must be sold short.
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> Rule 200(g) of Regulation SHO requires a broker-dealer to mark sell orders in any equity security as "long" or "short." Rule 200(a) defines a short sale as "any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller." Rule 200(g)(1) provides that "[a]n order to sell shall be marked "long" only if the seller

> is deemed to own the security being sold pursuant to paragraphs (a) through (f) of this section and either: (i) The security to be delivered is in the physical possession or control of the broker or dealer; or (ii) It is reasonably expected that the security will be in the physical possession or control of the broker or dealer no later than the settlement of the transaction." Rule 200(c) of Regulation SHO provides that a person shall be deemed to own securities only to the extent that he has a net long position in such securities. In addition, to determine its own net position, Rule 200(f) requires a broker-dealer to aggregate all of its positions in a security unless it qualifies for independent trading unit aggregation.
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> *Thus, under the above-mentioned scenario, if the seller is long 500 shares, the sell order for the sale of such 500 long shares must be marked "long" and the sell order for the sale of the additional 100 shares must be marked "short."*
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> Furthermore, Rule 17a-3 requires, in part, that "[e]very member of a national securities exchange who transacts a business in securities shall make and keep current books and records relating to its business" including a memorandum of each order which shall show the terms and conditions of the order or instructions. The memorandum must include accurate terms and conditions of the order. Thus, the order must be marked to accurately reflect that part of the order is long and part of the order is short."

(emphasis added).

Up until the Division Staff's FAQ, BATS understands that in the above scenario it was common industry practice, especially when a firm was acting as agent for a customer, to send a single order and take the conservative approach of marking the entire order short. Once again, until now the industry practice was explicitly supported by previous SRO interpretations. In particular, FINRA Notice to Members 94-68 contains the following question and answer:

> **Question #21:** If a member is long 500 shares and wants to sell 600 shares, the firm may treat this either as a long sale for 500 or a short sale for 100 (two reports), *or it may mark the entire order as a short sale*. But if a member is long 500 shares and sells 535, what do you do?
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> **Answer:** The short sale rule does not apply to odd-lots, therefore the order may be marked and executed as a long sale.

(emphasis added).

While the approach supported by FINRA has long been common industry practice, the Division Staff now appears to be suggesting that this approach is no longer appropriate. Rather, the Division Staff's view is that broker-dealers must break up the order and send the long portion as long and the short portion marked short. BATS is concerned that the Division Staff's

approach, which would appear to be the first ever mandate to break up orders, could result in customers receiving worse prices than they otherwise would have received had a single order been routed on their behalf. At a minimum, BATS again believes that the above FAQ represents a significant departure from prior industry practice.

Furthermore, the Division Staff has not articulated a compelling substantive policy reason for requiring firms to adopt such an approach, other than for books and records purposes. While BATS believes that accurate books and records are an important component of a broker-dealer's compliance obligations, the Division Staff's interpretation may not further that goal because there are still likely to be scenarios in which orders are inaccurately marked based on the timing of when orders are executed (*e.g.*, the order marked short might actually execute when the firm's position is net long). This potential for order marking inaccuracy, combined with the potentially significant technical and compliance costs associated with requiring the industry to make such a change to long-standing order marking practices may outweigh the theoretical books and records benefit the Division Staff is seeking through this FAQ. As such, BATS believes that the Commission should intervene and instruct Division Staff to withdraw this FAQ pending potential rule-making to determine its consistency with the Exchange Act.

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BATS believes that the Division Staff's FAQs referenced above may represent a substantial departure from industry understanding and, with respect to FAQ 2.5, create an objective standard of compliance from what appears to be a subjective requirement under Regulation SHO. In addition, BATS is concerned that compliance with FAQ 2.5 will have the effect of dramatically distorting the true level of short sell activity in the market. As stated above, BATS is concerned about the appropriateness of the Division Staff's interpretations as articulated in these FAQs and believes that to the extent the Division Staff intends to have created enforceable obligations, these FAQs should be subject to notice and comment before becoming effective. Please do not hesitate to contact me if you have any questions.

Sincerely,

Eric Swanson
SVP & General Counsel
BATS Exchange, Inc.

cc: The Hon. Kathleen L. Casey, Commissioner
The Hon. Elisse B. Walter, Commissioner
The Hon. Luis A. Aguilar, Commissioner

The Hon. Troy A. Paredes, Commissioner
David M. Becker, General Counsel
James Brigagliano, Co-Acting Director, Division of Trading and Markets
Josephine Tao, Assistant Director, Division of Trading and Markets

TEL. 913.815.7000 | FAX. 913.815.7119 | 8050 MARSHALL DR., SUITE 120 | LENEXA, KS 66214 | BATSTRADING.COM