

**STA**

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# Security Traders Association

## TRADING ISSUES COMMITTEE

### RECAP

April 1, 2009

**Participants:** Brett Mock and Tony Sanfilippo, Co-Chairmen; Peggy Bowie, Joe Cangemi, Stan Craig, John Daley, Peter Driscoll, Joanna Fields, Steve Kay, Damian Maroun, Lou Matrone, Brian McCarthy, David Mortimer, Terry Mulry, Stephen Nelson, Jeff Nordstrom, Jerry O'Connell, Rory O'Kane, Jay Owen, Frances Proctor, Joe Roman, Jon Schneider, Matt Steadman, Kim Unger and Bill Vance of the Trading Issues, Institutional and Affiliate Liaison Committees; Steve Blumenthal, Dave Franasiak and Joel Oswald of Williams & Jensen; Special Guests Len Amoruso, General Counsel, Knight Capital Group, Inc., Eric Hess, General Counsel, DirectEdge, Brian Hyndman, Senior Vice President, NASDAQ OMX, Chris Isaacson, Senior Vice President and COO, BATS Trading, Joseph Mecane, Executive Vice President and CAO U.S. Markets, NYSE and Jim Young, Chief Regulatory Officer, NSX; and Gilda DiTullio of the Staff.

### EXCHANGES ON MODIFIED UPTICK RULE LETTER TO THE SEC

Joe Mecane spoke on behalf Brian Hyndman, Chris Isaacson, and Jim Young regarding the letter sent by the Exchanges (NYSE, NASDAQ OMX, BATS Trading and NSX), highlighting the issues addressed, along with the rationale:

- The two main issues the debate is about are:
  - Whether a price-type test is warranted; and
  - What form it should take.
- Through the SEC comment process, both issues will be discussed at length.
- The Exchanges' view centered around several issues:
  - It would be difficult to implement the old tick test in the current market.
  - They wanted to suggest something along the lines of NMS, which is more implementable from the brokers' standpoint.
  - This is an opportunity to correct some of the flaws in the tick test.
- The concept centered on the idea of passive short selling.
  - Nothing as onerous as stopping or restricting short selling, but mitigating the downward pressure short selling could put on a stock.
  - Requiring a passive posting above the bid with a 10% drop as a placeholder for when that would kick in.
  - Since they did not think the passive concept should always be in effect, they wrapped in a circuit breaker.
  - They agree with the concept of effective enforcement of naked short selling.

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- They didn't go into detail or address exceptions that should work themselves out during the comment period, because the letter was written in a limited timeframe.
- Rigorous enforcement of abusive behavior will need to be addressed further.

During the ensuing discussion, it was noted the exchanges did not want to stop short selling. Instead, they were attempting to mitigate the rapid declines in a stock that could happen from repetitive short selling. If a stock got back to flat, the restriction would be revoked, which is a detail that could be solved by the community.

To make it more implementable the exchanges shifted from the previous form of a tick test to a policy and procedures concept around a percentage move in the stock, with the expectation that the industry would disseminate a condition code.

One concern is the exchanges won't be on a level playing field with dark pools, which they anticipate will be worked out during the comment period.

Long sellers will be able to continuously and aggressively sell.

Overall, the exchanges' proposal will satisfy the political pressure in D.C., without having too much of an impact on the client.

### **COMPLIANCE/TECHNOLOGY PERSPECTIVE**

Co-Chairman Mock introduced Len Amoruso, General Counsel, Knight Capital Group, Inc. who made the following comments regarding the Exchanges' proposal:

- The proposal is not entirely unreasonable, given the fundamental premise of what is being raised on the Hill.
- The compliance costs associated with implementing procedures for surveilling and monitoring the rule could be significant.
- If implemented, the Exchanges' proposal will not likely result in a decrease in liquidity because, hopefully, it won't be triggered very often.
- There is no assurance a tick test will help to restore investor confidence or stabilize the volatility.

During the following discussion, it was noted that monitoring a tick test will be a significant undertaking. Additionally, it was agreed the associated costs will be passed onto the broker/dealers.

In preparing the letter, the exchanges felt knowing what the protective bid is should help to mitigate the amount of work required by broker/dealers to comply with the rule. Hopefully, some of the work done for Reg NMS could be leveraged if the tick test gains traction.

## **DIRECTEDGE SHORT SALE LETTER TO THE SEC**

Eric Hess, General Counsel to DirectEdge, was introduced to discuss the letter they wrote after seeing the Exchanges' proposal.

- There is a significant amount of empirical evidence that suggests the tick test is an ill-conceived direction, which should be made public and be part of the debate. In fact, this is supported by a publication by the SEC Office of Economic Analysis.
- A liquid and transparent market should not be imposing restrictions on liquidity. Instead, the rules of conduct should be regulated by tightening naked short sales if warranted, and try to enforce the existing rules.
- There should be higher disclosure requirements to the regulators for both equity and synthetic shorts. Fundamentally, there should not be a regulatory approach that favors one type of liquidity over another.
- Circuit breakers and giving credence to the notion of regulating on a stock by stock basis is not supported by empirical studies.
- One threshold problem that they see in the modified tick test proposal is that taking on a short position in a lot of algos will lead to accelerated short selling as the threshold is approached.
- Empirical studies referenced in their letter support the fact that a tick test would only have a temporary impact on stability.

During the subsequent discussion, it was noted that DirectEdge raised some of the same comments STA addressed in its comment letter.

The compliance burden imposed by an uptick rule on the smaller shops will need to be addressed.

As an industry, we need to figure out how to satisfy some of the political issues without destroying the markets—one of the last bastions of liquidity in the U.S.

## **WASHINGTON UPDATE**

Dave Franasiak, Joel Oswald and Steve Blumenthal reported on recent activities.

- There is a vigorous debate on the uptick rule and the comment letters are a focal point. The industry needs to continue to reach out to the Commissioners.
- Although there are no real specifics at this point, a few different proposals will be considered and there could be a bid test as well.
- Erik Sirri's interim replacement will be James Brigagliano. However, it is anticipated that Chairman Schapiro will ultimately bring her own team in.

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- The Fed has discussed repealing the mark to market, which will be highly incremental and take at least six months.
- Committees are continuing to look at regulation reform.
- The Administration has initial proposals to resolve the financial institutions that are non-banks.
- The Administration is discussing a single systemic risk regulator, but Chairmen Dodd and Frank are talking about a committee of regulators.
- The Treasury came out with a 61-page document regarding regulating non-banks, which would give them the authority to buy assets they currently do not have the power to take over.
- There is going to be a big push for legislation allowing people to sue credit rating agencies on their opinions.
- Congress will be off for two weeks in April.

### **NEXT MEETING**

The next meeting has been scheduled for Wednesday, May 13, because of a conflict with the STA Annual Washington Conference, May 5-6.

### **ADJOURNMENT**

The meeting was adjourned at 5:20 p.m.