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Via Email to: rule-comments@sec.gov

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-9303
Attention: Nancy M. Morris, Secretary

Re: File No. S7-19-07 – Amendments to Regulation SHO

Ladies and Gentlemen:

This letter is submitted on behalf of the Committee on Federal Regulation of Securities (the "Committee") of the Section of Business Law of the American Bar Association (the "ABA") in response to the request of the Securities and Exchange Commission (the "Commission") for comments on proposed amendments to Regulation SHO contained in Exchange Act Release No. 56213 (the "Proposing Release").[1]

The comments expressed in this letter represent the views of the Committee only and have not been approved by the ABA's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, this letter does not represent the official position of the ABA Section of Business Law, nor does it necessarily reflect the views of all members of the Committee.

I. Introduction

The Committee would like to thank the Commission for this opportunity to comment further on the proposed changes to Regulation SHO. We commend the Commission and the staff for your continuing efforts to evaluate the effectiveness of Regulation SHO, and for your

[1] Exchange Act Release No. 56213 (Aug. 7, 2007), 72 Fed. Reg. 45558 (Aug. 14, 2007) (the "Proposing Release").

time and efforts in proposing changes where you have perceived the need for change. The Committee supports the Commission's efforts to reduce persistent fails to deliver, and to bring clarity to the provisions of Regulation SHO.

II. Need for Evidentiary Support and Publication of Data

As the Committee commented in its September 27, 2006 letter to the SEC ("2006 Letter") regarding the amendments to Regulation SHO proposed in Exchange Act Release No. 54154 (the "2006 Proposal"),[2] we believe the Commission should adopt rule changes, including these proposed changes to Regulation SHO, only if the Commission has substantial reason to believe that such changes are necessary after providing the public with the opportunity to comment on the information providing the basis for the rulemaking. The Committee appreciates that the Commission specifically recognized the Committee's concerns when it re-opened the comment period for the 2006 Proposal earlier this year, and we urge the Commission to consider the continued need to show evidence of a problem, that the proposed rule amendments will address the problem, and that the benefit will outweigh the burden.[3]

Notwithstanding Regulation SHO's administrative history, the Proposing Release includes very little empirical data to support rescinding or amending the options market maker exception or imposing long sale documentation requirements. Accordingly, and setting aside any specific views on either amendment, the Committee once again reiterates its concern that the Commission, as required under the Administrative Procedures Act ("APA"), provide the requisite factual material forming the basis for its rulemaking and allow an opportunity for public comment informed by such material. As we previously stated in our comment letter on the 2006 Proposal, Section 553 of the APA requires that the Commission make the information supporting the agency's rulemaking available for public review and evaluation.[4] Moreover, as the U.S. Court of Appeals for the D.C. Circuit stated in *Chamber of Commerce v. SEC*, the APA requires "the 'most critical factual material' used by [an] agency be subjected to informed comment … to ensure that agency regulations are tested through exposure to public comment, to afford affected

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[2] Exchange Act Release No. 54154 (July 14, 2006), 71 Fed. Reg. 41710 (July 21, 2006).

[3] Exchange Act Release No. 55520 (Mar. 26, 2007), 72 Fed. Reg. 15079 (Mar. 30, 2007) ("2007 Re-Opening Release").

[4] *See Chamber of Commerce v. SEC*, 443 F.3d 890, 899 (D.C. Cir. 2006) (citing *Solite Corp. v. EPA*, 952 F.2d 473, 484 (D.C. Cir. 1991)).

parties an opportunity to present comment and evidence to support their positions, and thereby to enhance the quality of judicial review."[5]

III. Comments on the Proposed Elimination of or Amendments to the Options Market Maker Exception

As a preliminary matter, the Committee reiterates the comments set forth in our 2006 Letter relating to the options market maker exception. In addition, as discussed above, we continue to believe that the Commission has provided insufficient factual basis to support the proposed amendments. Despite extending the original comment period and now re-proposing the amendments to the options market maker exception, the only support offered continues to be limited anecdotal information from the Commission's Office of Compliance Inspections and Examinations ("OCIE") and self-regulatory organizations ("SROs"), but not made available to the public.[6]

The limited examples of instances where fails to deliver involved options market makers do not indicate that options market makers were actually responsible for the fails to deliver, and do not show a cause and effect between reliance on the existing exception and fails. Far from demonstrating that the options market maker exception is a cause of persistent fails to deliver, the information provided by the Commission and the SROs suggest only the continued misunderstanding and misapplication of the exception by certain options market makers.

Specifically, the NYSE reviewed five securities with substantial aged fail positions from July 1, 2005 through September 23, 2005, and found that the fail positions in these five securities were attributable to one broker-dealer, who "informed the NYSE that the fail positions were not being closed out because it was relying on the options market maker exception."[7] The fact that each of only five fail positions were attributable to one broker-dealer relying on the exception provides no indication as to whether the broker-dealer at issue was even eligible to *claim* the exception. Similarly, as the Commission noted, "[OCIE] conducted some examinations for Regulation SHO compliance and found that some broker-dealers were still carrying a significant amount of fails to deliver in securities that they were not closing out because they were relying on the grandfather provision. One broker-dealer indicated that it had not closed out several persistent fails in threshold securities because it was relying on the options market maker

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5 *Chamber of Commerce v. SEC*, 443 F.3d at 900 (quoting *Ass'n of Data Processing Serv. Orgs., Inc. v. Bd. of Governors of the Fed. Reserve Sys.*, 745 F.2d 677, 684 (D.C. Cir. 1984)).

6 *See* Proposing Release, 72 Fed. Reg. at 45560, n.27.

7 2007 Re-Opening Release, 72 Fed. Reg. at 15080.

exception."[8] Citing one broker-dealer, however, does not demonstrate that there is a widespread problem requiring elimination of the exception.

FINRA's information is similarly deficient.[9] FINRA analyzed securities that appeared on NASDAQ's Regulation SHO Threshold List and found 148 unique securities on NASDAQ's Regulation SHO Threshold Lists for a period of 40 days or longer. FINRA found that "for 5 unique issues, fails to deliver in the NSCC system were held by one or more member firms known to provide clearing services for registered options market makers. It appears these positions may have been exempt from the close out requirement ... pursuant to the bona fide market maker exemption." FINRA also found that "for 22 unique issues, 1) fails to deliver in the NSCC system existed prior to the security becoming a Regulation SHO Threshold security and remained in place for all or part of the review period; and 2) fails to deliver in the NSCC system were held by one or more member firms known to provide clearing services for registered options market makers. It appears that these positions may have been exempt from the close out requirements of Regulation SHO under the 'grandfathering' and/or bona fide options market maker exemptions as defined in SEC Rules 203(b)(3)(i) and 203(b)(3)(ii)." FINRA, however, failed to link any of the fails to one or more of the options market makers. Moreover, the small number of fails to deliver (*i.e.*, 5 and 22 out of 148) that the Commission believes *may* be attributable to the options market maker exception do not justify eliminating the exception entirely. We would expect the Commission's rulemaking to be supported by stronger empirical evidence, and if such evidence does form the basis of its proposed rulemaking, we would expect it to be made available to the public.

The Commission acknowledged that fails to deliver could be attributable in some cases to either the grandfather exception or the options market maker exception. In light of the lack of evidence, the Committee believes that the Commission should wait to see how the elimination of the grandfather clause effects the frequency of persistent fails. As the data provided was collected before the elimination of the grandfather clause, it is too soon to tell whether persistent fails will continue to be a problem such that the Commission would need to re-visit the issue. Rather than making amendments at this time, we would encourage the Commission to conduct a study of fails to deliver to develop a holistic solution to the issue of persistent fails. We also believe that more efforts by the Commission and the SROs to educate market participants about the requirements of Regulation SHO and particularly the scope of the options market maker exception, such as the recent efforts by the American Stock Exchange and Chicago Board

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[8] *Id.*

[9] *See* File No. S7-12-06, Comments of the National Association of Securities Dealers, Inc. (Mar. 12, 2007); Proposing Release, 72 Fed. Reg. at 45559, n.19.

Options Exchange, would be a prudent step prior to eliminating or revising this exception.[10] To avoid any unnecessary and unintended adverse consequences, and in light of the importance of hedging activity to options market making, we believe that the Commission should undertake these efforts prior to eliminating the exception for options market making.

IV. Comments on the Long Sale Provision

The Committee similarly does not believe that the Commission has provided the necessary factual support to demonstrate a problem with mismarking sales as "long", and that the proposed long sale documentation requirement of Rule 200(g)(1) would reduce the number of fails to deliver. In particular, the Committee is concerned that the Commission's cost estimates do not reflect delivery versus payment ("DVP") accounts, which are widely used by broker-dealers' institutional clients. Although former NASD Rule 3370(b)(1), which is essentially the predecessor of proposed Rule 200(g)(1), contained an exception for DVP trades,[11] proposed Rule 200(g)(1) does not include a similar exception. Accordingly, we believe that it is important that the Commission's cost estimates reflect the additional burden on broker-dealers' documenting long sale positions held outside the broker-dealer, a process that would not easily lend itself to automation.

A key impediment to documenting the location of securities sold long is that many institutional investors maintain DVP accounts with multiple executing brokers, and custody securities with multiple prime brokers or banks. As proposed, institutional customers' will need to implement a process for feeding information to their order desks so that their individual traders can identify to the broker the particular managed account for which securities are being sold. This means that buy-side customers as well as broker-dealers will face significant burdens and costs in tracking the specific securities sold in particular trades and driving that information to the customers' order desks and on through to the executing broker. We do not know, nor has the Commission provided any estimate of, the costs of this process to institutional investors. The Committee believes that the Commission must determine and make public its basis for the costs to both buy- and sell-side customers of the proposed long sale documentation requirements, including for DVP accounts, prior to adopting this requirement. The Commission's cost estimates should reflect whether automated solutions are, in fact, viable for particular types of account arrangements.

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[10] CBOE Regulatory Circular RG 07-87 (Aug. 9. 2007) http://www.cboe.org/publish/RegCir/RG07-087.pdf; and Amex Notice REG 2007-35 (Aug. 9, 2007) http://www.amex.com/amextrader/?href=/amextrader/tdrInfo/data/axNotices/2007/reg07035.html.

[11] Proposing Release, 72 Fed. Reg. at 45574.

While the Commission acknowledges that long sale documentation requirements will delay the execution of orders, it does not provide any estimates of the impact to investors of the increased execution costs resulting from having to work orders in the market to obtain executions, or the opportunity costs resulting from missed executions. The Committee believes that prior to imposing this additional documentation requirement the Commission should publish for public notice and comment reasonable - and realistic - estimates of the increased costs to the investing public as well as to broker-dealers and institutional investors.

Moreover, prior to imposing long sale documentation requirements, the Committee believes that the Commission should demonstrate the link between the absence of documentation of the location of securities sold long and fails to deliver. We believe that such an evidentiary basis will be possible only with a comprehensive study of fails. If, however, the Commission decides to adopt the proposed amendment, the Committee recommends that new Rule 200(g)(1) include an exception for DVP trades similar to the exception provided under former NASD Rule 3370(b).

V. Conclusion

The Committee appreciates the opportunity to submit these comments. Members of the Committee are available to meet and discuss these matters with the Commission and its staff and to respond to any questions.

Respectfully submitted,

/s/ Keith F. Higgins

Keith F. Higgins
Chair, Committee on Federal Regulation of Securities

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