

December 11, 2008

Via Electronic Filing

Florence E. Harmon
Acting Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Amendments to Regulation SHO, Rel. No. 34-58773; File No. S7-30-08

Dear Ms. Harmon:

The Investment Adviser Association (“IAA”)¹ appreciates the opportunity to comment on interim final temporary Rule 204T under the Securities Exchange Act of 1934.² The IAA supports the Commission’s goal of preventing substantial disruptions in the securities markets, particularly in these turbulent times. The Commission’s new rule, which requires broker-dealers to close out fail-to-deliver positions is, however, resulting in unintended and potentially negative consequences for investors and their investment advisers that are selling long. As noted below, we believe the Commission should address the potential exposure to price fluctuations that investors and their investment advisers are facing from broker-dealers closing out of positions before the deadline under Rule 204T.

Rule 204T

Out of concern regarding the “potential impact of naked short selling on the weakened financial markets,” the Commission adopted Rule 204T to address abusive “naked” short selling in all equity securities. Specifically, Rule 204T requires fail-to-deliver positions to be closed out by no later than the beginning of regular trading hours on the settlement day following the day the fail-to-deliver position occurs. A participant of a registered clearing agency that does not comply with this close-out requirement, and any broker-dealer from which it receives trades for clearance and settlement, will not be able to short sell the security

¹ The IAA is a not-for-profit association that exclusively represents the interests of investment adviser firms registered with the SEC. Founded in 1937, the Association’s membership consists of more than 500 firms that collectively manage in excess of \$9 trillion in assets for a wide variety of institutional and individual clients, including pension plans, trusts, investment companies, endowments, foundations, and corporations. For more information, please visit our web site: www.investmentadviser.org.

² *Amendments to Regulation SHO*, Exchange Act Rel. No. 58733 (Oct.14, 2008), available at <http://www.sec.gov/rules/final/2008/34-58773.pdf> (Interim Release).

either for itself or for the account of another, unless it has previously arranged to borrow or borrowed the security, until the fail-to-deliver position is closed out.

Rule 204T provides an exception from the close-out requirements for fail-to-deliver positions resulting from long sales of equity securities. If a participant of a registered clearing agency can demonstrate that a fail-to-deliver position resulted from a long sale, the participant is granted until the beginning of regular trading hours on the third consecutive settlement date following the settlement date immediately to close out the fail-to-deliver position by purchasing securities of like kind and quantity (T+6). The Commission also incorporated the guidance it previously provided on the effect of the short sale rules on the sale of securities out on loan. In the Interim Release, the Commission noted that the sale of a loaned security for which a bona fide recall has been initiated within two business days after trade date will not be treated as a short sale for purposes of Rule 204T.³ Therefore, sales of securities out on loan would be treated as a long sale and a clearing agency participant or broker dealer also would have until the beginning of the third consecutive settlement date following the settlement date to close out the position of these sales.

Early Close-Outs by Broker-Dealers under Rule 204T May Potentially Harm Investors

Although clearing participants (and broker-dealers in turn) have until T+6 to close out the fail-to-deliver position for a long sale of equity securities, clearing participants and broker-dealers are not required under Rule 204T to wait until the end of this deadline to close out a position. The rule simply provides the maximum time period for closing out a position. We understand, however, that the emphasis placed by the Commission on closing-out all fail positions and the penalty imposed by Rule 204T for failing to close-out positions have resulted in broker-dealers closing out positions as early as T+4.⁴ Closing out a position before the T+6 deadline could potentially harm investors by exposing them to price fluctuations. This situation can and does arise for regular long sales and for sales of securities out on loan.

To illustrate, closing out long positions before required by Rule 204T causes investors to be exposed to the differential between the sale price and the buy-in price of the security. Especially in a turbulent market, such as the one we are currently experiencing, this type of exposure can be significant. Moreover, if a client's investment manager sells a security out on loan, and the broker-dealer effects a buy-in of the security before the custodian or securities lending agent is able to return the security, the client would still own the security out on loan, which was returned on a timely basis but after the buy-in. The investment manager's investment decision would be nullified, and the client could end up bearing the market risk of holding the security. We note that the investment manager may not be aware that the client has entered into a securities lending arrangement, and even if it is aware of the arrangement, it will not have information regarding the specific securities on loan. In addition, it is not clear which entity is responsible for the difference (if any) of the sale price

³ See Footnote 70 of Interim Release *supra* note 2.

⁴ We understand that in some cases broker-dealers are not able to distinguish between long and short sales, which results in these broker-dealers treating all sales as short sales to be closed out by T+4.

and the buy-in price because no mistake was made on the part of the investor or its investment adviser or the borrower or lending agent that returned the securities on time.

Further aggravating this problem is the lack of uniformity in how buy-in notices are provided to investors and in the amount of time provided between the buy-in notices and the buy-ins. We understand that the practices of broker-dealers vary greatly with regard to the timing and form of notice provided to investors and their advisers before the broker-dealer buys-in the security. In some situations, investors and their custodians may not receive sufficient notification of the broker-dealer's intention to effect a buy-in or may not have a reasonable time to deliver a security upon receiving the buy-in notice (*e.g.*, notice at 6 p.m. and buy-in at the next day's open).

Recommendations for Amendments to Final Rule 204T

To prevent investors and their investment advisers from being exposed unnecessarily to market fluctuations, especially in times of market turbulence, the IAA offers two suggestions. First, the Commission should clarify that investors and their investment advisers are not responsible for the market price changes when a long position is closed out before the time permitted under Rule 204T.⁵ We believe that the Commission in its attempt to prevent abusive "naked" short selling did not intend to affect negatively ordinary investors; these investors should not bear the consequences of early close outs.⁶

Second, the Commission should consider whether broker-dealers should be required to provide buy-in notices at least 24 hours before a position is closed out. This minimum advance notice would give an opportunity for the investor or the custodian to cure the fail. Any shorter timeframe would be unreasonable. We would welcome consideration of these or any other appropriate amendments to Rule 204T to address this important issue.

As a more general matter, the Commission should encourage a uniform automated system for buy-in notices. A system in which buy-in notices are simultaneously provided to investors, their advisers, and their custodians would greatly facilitate delivery of securities and reduce the number of fails or buy-ins that are preventable. The lack of automation and uniformity in this process contribute to the potential for fail-to-deliver securities.

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⁵ We urge the Commission to provide this guidance before a final rule is adopted in the form of a Frequently Asked Question or another appropriate forum. We do not believe that this issue should remain outstanding until the final rule is adopted or the expiration of the interim final temporary rule on July 31, 2009.

⁶ Similarly, it appears that investors and their investment advisers may at times inappropriately bear the consequence when securities out on loan are not returned in time. We understand from some of our members that some custodians that do not return securities out on loan before the morning of T+6 (when the broker-dealer is required to close out the position) do not take responsibility for the difference in the sale price and the buy-in price of the security, even though they are contractually obligated to return the security on a timely basis.

The IAA strongly supports the Commission's efforts to prevent abusive "naked" short selling and to stabilize the securities markets. We, however, are concerned that the rule adopted by the Commission may have an unintended consequence of exposing investors and their advisers to price fluctuations because broker-dealers are closing out long positions earlier than T+6. We appreciate the opportunity to provide our views on these issues and would be pleased to provide any additional information. Please contact the undersigned or Karen L. Barr, General Counsel, at (202) 293-4222 with any questions regarding these matters.

Respectfully submitted,

/s/ Jennifer S. Choi

Jennifer S. Choi
Assistant General Counsel

cc: The Honorable Christopher Cox, Chairman
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
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