April 18, 2008

I write to support proposed Petition 4-557. The overall remedy appears to be restitution in the event of a broken trade (a failure to deliver "legally authorized and issued securities" – hereinafter, and in accordance with the definition thereof in the U.S. Securities laws, "securities"). Assuming for the moment the desirability of that remedy (and I suggest an alternative below), I am unclear over the language of subsection 1(d), and I believe it could be improved.

Subsection 1.(d) currently reads as follows: in the event of a broken trade "at the end of the settlement cycle, any securities credited to customer accounts are to be debited from customer accounts in the same number and of the same type as those that broker-dealers failed to obtain on behalf of customers[.]" This is confusing, but it appears intended to cover what is supposed to happen at the end of the settlement cycle in the event of a failed delivery of legally authorized and issued securities, from a seller's account, of all or a portion of a buyer's purchase order of such securities to the buyer's account. As outlined in the background of the proposed petition, it is quite possible these days (and may indeed be likely) that any particular brokerage customer's account may consist of "securities" (*i.e.* legally authorized and issued) and it may also consist of mere "securities entitlements."

Securities entitlements are of at least two types: those that have been immediately credited to a customer's account at the moment a trade is executed and prior to the settlement date (*i.e.*, during the pendency of T+3), and those continue to exist in a customer's brokerage account – unlawfully, as the proposed petition makes clear – after the T+3 date of settlement. Now, suppose a swing-trader's brokerage account indicates holding 1000 shares of XYZ Corp. that were acquired in two trades: at T+1 and at T+10. The T+1 trade has yet to settle, and therefore it lawfully consists of mere "securities entitlements" that are supposedly tied to the underlying security to which they are attributable (i.e., the securities whose delivery is supposedly forthcoming at or by T+3). The T+10 trade by this time is supposed to consist of actual legally-authorized-and-issued shares. As described in the background for the proposed petition, insofar as the trader can discern from examining his brokerage account, that appears to be the case, for his brokerage account does not discriminate between securities entitlements and "securities" (legally-authorized-and-issued). But now assume for the sake of argument that the T+10 shares actually consist of lawful "securities" and also mere securities entitlements because of a partial delivery failure at T+3 for the trade that is now at T+10. Further assume that the T+1 purchase was for 300 shares, that the trader's total holdings of "securities entitlements" in XYZ Corp. is 500 shares, and that the remaining 500 shares in is lawful "securities."

If the swing-trader now sells his T+1 holdings (300 shares) as well as 200 shares of his remaining position to another buyer for a profit of $100 (or a loss of $100), then in the event the buyer from whom the swing-trader purchased his T+1 shares winds up breaching his delivery obligation by failing to deliver at the promised securities by T+3, what is the impact of the proposed "Customer Account Rule" upon our swing-trader's good-faith trade to a subsequent buyer? And at this point, is there any appreciable difference between the lawful (T+1) and the unlawful (T+10) securities entitlements in his brokerage account? Regardless, if our swing-trader fails to deliver by T+3 and his sell (trade) is to be unwound and amounts and securities restored to his account, then one interpretation of currently proposed subsection 1(d) is to put the onus on his broker to restore to his brokerage account <u>actual</u> securities (lawfully authorized and issued) and not merely re-credit his account with "securities entitlements." Is that what this subsection states or attempts to accomplish? If so, then does this proposed Rule put enough pressure on his broker to put, in turn, enough pressure on the broker who remains responsible for the original delivery failure to our swing trader's account?

Again, the proposed remedy appears to attempt to "unwind" a trade that fails to deliver securities paid for. If that is the preferred solution, then from a fairness, not to mention administrative, perspective, it would be preferable to modify proposed Section 1 of the Rule (subsections (a) through (c)) to provide for "expectation" damages to the buyer for a security that fails delivery, *e.g.*, the closing price of the security as of T+3, with the responsibility therefor being borne by the non-delivering broker of the seller. As for the customer of a broker who sold the "securities" that ultimately failed delivery to the buyer's broker by T+3, the unwinding of the trade should involve re-crediting the selling customer's brokerage account only with lawful securities entitlements, not the "unlawful" securities entitlements that may have lead to a subsequent delivery failure when such "securities" are sold to another buyer.

For that reason, because investors and traders ought to be allowed to rely in good faith upon the clearance and settlement system, from the foregoing it may be deduced that the simplest and most practicable solution for tacking existing and future deliver failures is not to be "backward looking" and "unwind" a broken trade, but to be forward looking and put the onus on the seller's broker by requiring, <u>without exception</u>, <u>delivery by T+3</u> of "securities" lawfully authorized and issued – and those does not include broker-created "securities entitlements" – with penalties for delivery failure as outlined in subsection 4.

Other suggestions:

Section 1.(a) : The third line should read "obtain" not "obtained."

Sections 2.(b) and 3.(b) : Inserting "of securities" between "number" and "broker-dealers" would add clarity.

Section 4.: I suggest changing "person" in subsection 4 to "broker/dealer" (see discussion *supra*).

Signed,

Anonymous