THE SUMMIT GROUP

Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-0609

September 29, 2006

Re: Amendment to Regulation SHO
File No. S7-12-06

Dear Ms. Morris:

I appreciate the opportunity to offer my opinions regarding proposed amendments to Regulation SHO (Reg SHO). I have spent more than 30 years in the securities industry, and am a frequent speaker and the author of books and articles on securities industry operations. I am currently a Managing Partner of The Summit Group, which is active in consulting with major banks, brokers, investment managers and other financial institutions on systems integration and market operations matters. Through one of our subsidiaries that specializes on the education of securities processing professionals, we annually reach thousands of industry professionals in the U.S. and around the world via newsletters, educational sessions, Learning and open forums as part of our mission to improve the efficiency and effectiveness of their operations.

It is based on my experience that I applaud the thorough, fact-based process the Commission has adopted for the important work it is undertaking to end short selling abuses. I think it is imperative that these illegal tactics be eliminated and that new, reasonable procedures be employed to close fails to deliver (FTDs), particularly if persistent fails are found to enable illegal trading practices.

There has been a certain amount of media attention around the issue of short selling abuses and, as a consequence, a number of proposals have been advanced to eliminate the problem. Some of these proposals, however, would be harmful to the efficient and effective operations of our markets including those which call for greater participation by the states in the regulation of the securities industry. In my view, these proposals would weaken the SEC's constitutionally-mandated authority and would therefore be a significant setback to investor protection and efficient market practices. As reform proposals are made, I believe it is important to remember that the U.S. capital markets are healthy and robust. The ability of our markets to clear and settle trades quickly, accurately and inexpensively provides important competitive advantages that, in turn, provide significant economic benefits to this country.

I am confident the Commission will proceed both expeditiously and carefully with its work to make Reg SHO more effective in curtailing short selling abuses. My full comments on the process are contained in the attached article, which appeared in the September 25, issue of Securities Industry News. I would appreciate it if you would accept this letter and the attached article and enter them into the public record on Reg SHO reform.

Sincerely,

Hal McIntyre
Managing Partner

Atch – Op Ed from Securities Industry News, dated September 25, 2006

Naked Short-Sale Reform: First Do No Harm
By Hal McIntyre
25 September 2006
Securities Industry News

Try as hard as you might to avoid it, if you're involved in securities market operations you've no doubt been exposed to skirmishes in the ongoing guerilla war over alleged illegal naked short selling. This protracted battle is already a modern miniseries that has it all. Internet bloggers--almost exclusively promoting the idea that securities markets are corrupt--pursue an anti-"Wall Street" and anti-Securities and Exchange Commission agenda. They often lump legal and illegal short selling into a single category and then raise alarmist cries that our markets are fatally flawed.

State officials, perhaps most famously in Utah, move to usurp the SEC's authority and undermine the system of federal regulation that has made U.S. markets the envy of the financial world. The CEO of a Nasdaq-listed company who has become famous on the "anti-naked-short-selling circuit" stumps the country on a mission to stamp out an alleged conspiracy to bring down his company through illegal short selling. And last, but far from least, a cohort of plaintiffs' attorneys aided by paid litigation consultants probe courts around the country, hoping to find a judge willing to rule that state law trumps federal securities market regulation.

In this environment, claims and counterclaims compete for public acceptance, and the "buzz" surrounding opinions and proposals that would do great harm if they were embraced threatens to disrupt the rational, fact-based process needed to enact reforms that hold real promise for addressing whatever short-selling abuses might exist while enhancing market operations by reducing fails. A recent example of this phenomenon is the promotion via the Internet of a comment letter to the SEC on Regulation SHO reforms. Touted by bloggers as unusually insightful, the comment letter characterizes all short selling as detrimental to investors, companies, and the markets as a whole. It puts forward numerous, inappropriate opinions and suggestions, including: forcing all failures-to-deliver to be closed at four days after the trade (T+4); automatically suspending or closing the Depository Trust & Clearing Corp. (DTCC) account of brokerage firms that default on the delivery of funds or securities by T+4; and giving power to the states to regulate the U.S. securities industry.

Not being an economist, I do not feel qualified to comment on the economic theories advanced as the foundation for these proposals. However, with more than 30 years of experience in securities industry operations, and with an unbiased perspective on the current debate, I feel fully qualified to state that adopting proposals such as these would have severe consequences--intended and unintended. Our clearance and settlement system, which is a model for efficiency and effectiveness across the globe, would be disrupted; processing costs would increase; and regulatory authority would be Balkanized--all without providing a quantifiable benefit to individual investors or to the industry overall.

Simply Deceptive

To elaborate on just one of the suggestions, the comment letter states that DTCC should "ensure settlement for all trades at T+3 and not allow failures beyond T+4." As a way to curtail illegal naked short selling, this proposal has the appeal of a simple solution to a complex problem, but it overlooks the realities of the marketplace. According to DTCC, more than 99.9 percent of trades settle on T+3, and 85 percent of those that do not settle on T+3 are cured by T+13. Since virtually all transactions clear in short order, it's logical to assume that the majority of the unsettled trades at T+3 exist for understandable and benign reasons such as unclear settlement instructions or mismatched information on the issue, quantity or price. They clear up relatively rapidly.

As remedies are developed, it's important to remember that while costly to resolve, fails such as these do not in any way affect the financial health of the markets. Yet the comment letter's recommendations would compel regulators to introduce new rules and burdensome procedures to fix a problem that has no lasting or meaningful effect on our capital markets.

In my view, if the measures put forward in the comment letter were adopted and severe changes are made in the overall fails process, illegal short selling might be prevented, but the markets would certainly be the worse for it. The tonic might cure the cold, but the market would surely end up with pneumonia.

As one who is opposed to illegal short selling, I think there are several fundamental questions to be answered, including: Can the U.S. securities industry process efficiently and safely with the current T+3 parameters? Is it acceptable from a market operations standpoint that a very small number of fails exist at T+4 and even beyond? Can we contain illegal short selling without affecting the rest of our securities processing?
The answers are yes, yes and yes. That is not to say that efforts at reform should be abandoned. For example, another logical question is: Should fails be allowed to remain open indefinitely? The answer clearly is no, particularly if long-term, persistent fails somehow enable or encourage illegal trading practices. I believe the industry's goal should be to eliminate illegal short selling without undue penalties for "routine" fails. That is to say, the industry and its regulators should be moving to tighten the deadlines for closing fails and levying significant penalties on the parties responsible for missing them. But certainly the existing regulations--the SEC's customer protection rule, among others--provide the right mechanisms to use to achieve these ends.

Orderly Deliberation

The markets are human inventions and the regulations that govern them are the result of our national commitment to ensure fairness. By announcing its goal to enhance Reg SHO and seeking comments from interested parties, the SEC demonstrates both its interest in reform and its commitment to an orderly process. Presumably, this process will result in rational proposals that will further, and hopefully significantly, reduce persistent fails.

Such an outcome would not only provide additional protections to the markets in the aggregate, but also lessen the chance that investors could be victimized by illegal short selling schemes. If the regulators determine that illegal naked short selling continues to take place after this round of reforms, regulations that are tighter still can later be enacted. Any solution should consider whether or not the marginal cost advantage of eliminating all fails is greater than the cost of compliance.

In the meantime, as the SEC moves to improve the system, everyone engaged in the process of reform should remember that the U.S. capital markets are robust and efficient. Over time, our systems have been automated and streamlined to allow for significant volume and diversity of participation. Tens of millions of transactions are executed each trading day and processed at an average DTCC cost last year of 7 cents per transaction, which compares very favorably to transaction costs in other countries. In the process, capital is allocated efficiently.

Our system works and is healthy, and we should be guarded in changing it when there is no empirical evidence that it is in need of an overhaul. We should recognize that attempts at comprehensive reform tend to result in compromises, while implementing a series of improvements allows the market to absorb the impact of each change and evaluate the need for additional steps.

During a time when flawed ideas threaten to take root, it's critical that we remember this basic admonition: "First, do no harm."