BINGHAM

Michael R. Trocchio
Direct Phone: 202.373.6167
Direct Fax: 202.373.6467
michael.trocchio@bingham.com

July 14, 2008

Ms. Florence E. Harmon
Acting Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: File No. S7-08-08; Release No. 34-57511
Proposed Rule 10b-21, the "Naked" Short Selling Anti-Fraud Rule

Dear Acting Secretary Harmon:

On behalf of Citigroup Global Markets Inc., Deutsche Bank Securities, Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated, Morgan Stanley & Co. Incorporated, and UBS Securities LLC (the "Firms"), we submit these comments in response to the above-referenced proposal to adopt new Rule 10b-21 ("Proposed Rule 10b-21" or the "Proposal") under the Securities Exchange Act of 1934 (the "Exchange Act"), as published in Securities Exchange Act Release No. 57511 (the "Proposing Release").[1]

The U.S. Securities and Exchange Commission ("Commission") has proposed adopting Proposed Rule 10b-21, a new rule designed to address its concerns, as well as the concerns that certain issuers and investors have expressed to the Commission, regarding failures to deliver securities and the possible negative consequences that might result from such failures.[2] Proposed Rule 10b-21 would make it unlawful for a person, in connection with an order to sell a security, to deceive a person participating in the transaction regarding the seller's intention or ability to deliver the security on the date delivery is due, and then fail to deliver the security by settlement date.[3] The Proposing Release specifically states that scienter would be required to find a violation of Proposed Rule 10b-21, although the text of Proposed Rule 10b-21 does not expressly contain this requirement.[4] The Firms appreciate the opportunity to comment on the Proposal.

Boston
Hartford
Hong Kong
London
Los Angeles
New York
Orange County
San Francisco
Santa Monica
Silicon Valley
Tokyo
Walnut Creek
Washington

Bingham McCutchen LLP
2020 K Street NW
Washington, DC
20006-1806

T 202.373.6000
F 202.373.6001
bingham.com

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1 Securities Exchange Act Release No. 57511 (March 17, 2008), 73 FR 15376 (March 21, 2008).

2 *See*, Proposing Release at 15378 (discussing the concerns expressed by issuers and investors about fails to deliver and stating that "one of the principal goals of proposed Rule 10b-21 is to reduce fails to deliver").

3 Proposing Release, 73 FR at 15378.

4 *Id.*

I. Summary of Comments

The Firms unequivocally oppose and condemn manipulation, abusive schemes and material misrepresentations made in connection with securities transactions. The Firms similarly oppose and condemn intentional failures to deliver effected for the purpose of driving down the price of a security. The Firms understand and appreciate the Commission's desire to address failures to deliver that are intended to adversely affect the price of a security. The Firms commend the Commission's continuing and vigilant efforts in this respect, including the Commission's willingness to consider the views of commenters and market participants. The Firms are concerned, however, that in the worthwhile effort to combat illicit conduct, the Commission is pursuing rulemaking that may not be effective and may have undesired consequences. Further, we would respectfully submit that the Proposing Release does not present a compelling evidentiary basis for the adoption of Proposed Rule 10b-21.

The Firms believe that the Commission's goals can be accomplished without rule-making. The Proposing Release states in multiple places that the Proposal is designed to "highlight" the liability of persons engaging in improper acts in connection with short sales. The Firms applaud the desire to better identify conduct that is inconsistent with the federal securities laws. At the same time, however, we are unaware of prior Commission rulemaking efforts that justified their purpose by relying so heavily upon the desire to "highlight" conduct that is already prohibited by existing securities laws and related rules. The Commission and its dedicated staff, in the past, have proven very proficient in effectively communicating their views on problematic conduct through less formal tools such as interpretive releases, FAQs, staff bulletins and public speeches before market participants. We would encourage that approach here rather than the Commission engaging in formal rulemaking.

If the Commission nevertheless determines to adopt a new rule specifically targeting failures to deliver securities in connection with short sales, the Firms believe that a rule aimed at misrepresentations by sellers (such as Proposed Rule 10b-21) is preferable to the Commission's 2007 proposal to require broker-dealers to document the location of securities in connection with orders marked "long" (the "Long Sale Documentation Proposal").[5] Furthermore, if the Commission does elect to adopt Proposed Rule 10b-21, the Firms offer a number of suggestions below to improve the Proposal.

[5] Securities Exchange Act Release No. 56213 (August 7, 2007), 72 FR 45558 (August 14, 2007) (the "Long Sale Documentation Proposing Release").

II. Comments

A. General Comments

The Firms unequivocally oppose illicit conduct, such as abusive naked short sales, that undermines the integrity and efficiency of our capital markets. The Firms appreciate the Commission's continued focus and diligence in monitoring failures to deliver, and understand the Commission's desire to address failures to deliver that are intended to adversely effect the price of a security.

Broker-dealers are harmed by misrepresentations that occur during the order entry process. When misrepresentations are made at the time of order placement and failures to deliver result, significant costs are imposed on broker-dealers. Indeed, the Commission noted that one benefit of the Proposal would be to "aid broker-dealers in complying with the locate requirement of Regulation SHO ...."[6] To help protect themselves from the negative consequences that flow from failures to deliver, broker-dealers generally maintain procedures designed to assure that orders are accurately marked and locates are obtained as necessary. Furthermore, the procedures are generally designed to monitor for failures to deliver by customers and to enforce compliance with the Commission's and FINRA's close-out requirements relative to reporting and non-reporting threshold securities.

Although the Firms support constructive efforts to reduce failures to deliver, the Firms do not favor unnecessary or ineffective rules, or rules that may potentially increase broker-dealer liability in an unwarranted fashion. The Firms are particularly concerned that the Proposal, if adopted as proposed, would potentially subject broker-dealers to costly lawsuits by private litigants for violations of Proposed Rule 10b-21, as well as potential liability in Commission enforcement actions for aiding and abetting the violations of others. In light of these risks, the Firms view the adoption of the Proposal as an option to be considered only after other reasonable measures have been exhausted.

The Firms believe that the adoption of a new rule must be premised on a demonstrated need and commensurate benefit. To the extent that misrepresentations are made during the order entry process, the Proposing Release lacks concrete factual information that evidences the frequency or impact of such misrepresentations. The Firms monitor failures to deliver in their ordinary course of business, and it has not been the Firms' experience that a material amount of failures to deliver can be associated with customer misrepresentations.

B. The Necessity of Evidentiary Support

The Firms do not believe there is adequate basis to adopt Proposed Rule 10b-21 as a means designed to reduce failures to deliver. Currently, when failures to deliver a

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[6] Proposing Release, 73 FR at 15380.

particular security exceed 0.5% of the number of shares outstanding for five consecutive settlement days, that security qualifies as a "threshold security" and is subject to strict close-out procedures. Once that threshold is met, the close-out requirement, if properly observed and enforced, should be sufficient to promptly clear-up failures to deliver and counteract any price impact.

Since Regulation SHO became effective in 2005, the Commission has determined that despite the requirements of Regulation SHO, certain securities continue to have a higher level of failures to deliver. In response, the Commission has proposed four rule changes (including the Proposal) to address failures to deliver. The Commission has adopted only one proposal thus far, the elimination in 2007 of the "grandfather" exception to the close-out requirement. These rulemaking efforts suggest that the Commission is earnestly searching for a solution despite the absence of evidence that conclusively points to the central cause of the problematic failures to deliver.[7]

Despite the Commission's several rulemaking efforts, it remains unclear why some failures to deliver persist, and the Proposal has not provided greater clarity into the problem of large and persistent failures to deliver. More specifically, the Proposing Release does not present data or analyses on persistent failures to deliver, the magnitude of failures to deliver caused by misrepresentations made at the time of order placement, or even address how failures were impacted by the termination of the grandfather exception. The absence of data has presented a significant challenge in evaluating the merits of the Proposal and in suggesting useful alternatives to address problematic failures to deliver. We are of the view that the Proposing Release does not establish a sufficient basis to support adoption of the Proposal – this sentiment was likewise expressed by commenters regarding the Commission's prior proposals.[8] In fact, we note that the Commission has recently provided additional data and re-opened the comment process on the proposed narrowing/elimination of the options market maker exception from the close-out requirement in response to comments regarding the lack of sufficient data in prior proposals.[9]

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[7] Not every failure to deliver adversely affects the price of a security. In fact, as repeatedly recognized by the Commission, the large majority of failures to deliver are the result of legitimate processing issues, do not affect the price of the security, and are cleared up within a few days. A number of written comments received by the Commission on the Proposal mistakenly suggest that every failure to deliver is nefarious and harmful.

[8] *See, e.g.*, letters from Keith F. Higgins, Chair of the Committee on Federal Regulation of Securities, Section of Business Law of the American Bar Association, dated Sept. 27, 2006 and Oct. 5, 2007.

[9] Exchange Act Release No. 58107 (July 7, 2008), available at *http://www.sec.gov/rules/proposed/2008/34-58107.pdf.*

In the Proposing Release, the Commission sets forth a number of possible negative consequences that result from failures to deliver securities.[10] However, the Commission does not provide any objective data concerning misrepresentations by sellers in the order entry process, nor does the Proposing Release offer any data connecting misrepresentations with actual failures to deliver or to securities with persistent fails.[11] While it is possible that misrepresentations made in connection with the order entry process could be responsible for persistent failures to deliver, the Proposing Release does not offer any data to substantiate such a link. The Firms believe the Proposal has failed to articulate a sufficient factual basis to justify adoption of a new rule and has not adequately demonstrated the benefit to be reaped from Proposed Rule 10b-21. The Firms believe, therefore, that the Proposal should not be adopted because there is not a sufficiently demonstrated need or benefit.

The desire for a disciplined rulemaking process that requires rigorous analysis and objective data to evidence the need for a proposed rule should not be misinterpreted or distorted to suggest that the Firms condone the practices targeted by the Commission. Nothing could be further from the truth. Rather, the Firms appreciate the important consequences that flow from the adoption of new rules and believe it is important that a strong foundation for Commission action be articulated and presented for comment. Equally as important in this case, the Firms believe Rule 10b-5 already prohibits the harmful failures to deliver the Commission seeks to address, so there seems to be little additional benefit to be derived from adopting an entirely new rule.

C. Interpretive Guidance

In the Proposing Release the Commission states several times that Proposed Rule 10b-21 "highlights" a practice that is already illegal.[12] The Firms agree that the illicit conduct

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[10] *See, e.g.*, Proposing Release, 73 FR at 15378 (stating that the Commission is "concerned that fails to deliver may have a negative effect on the market and shareholders" and that "sellers that fail to deliver securities on settlement date may be subject to fewer restrictions than sellers that deliver the securities by settlement date ... and ... may attempt to use this additional freedom to engage in trading activities that are designed to improperly depress the price of a security").

[11] As the Commission has acknowledged, failures to deliver in connection with long sales can occur for many legitimate reasons other than misrepresentations in the order entry process, for example because of delays in the processing of restricted stock, delays in the delivery of stock received as a result of option exercises, delays in the recall of stock loaned from margin accounts, and errors in communication between introducing and clearing brokers or prime brokers and custodians.

[12] *See, e.g.*, Proposing Release, 73 FR at 15376 ("proposed Rule 10b–21 would highlight the specific liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement ..."); *see also, e.g.*, Proposing Release, 73 FR at 15380 ("While "naked'' short selling as part of a manipulative scheme is already illegal under the general antifraud provisions of the federal securities laws, we believe that the proposed antifraud rule would highlight the specific liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement ...").

the Commission seeks to address through the Proposal is already illegal. The adoption of Proposed Rule 10b-21 would therefore appear to be redundant because the conduct of greatest concern to the Commission (misrepresentations that lead to failures to deliver which depress the price of a security) is already illegal under Rule 10b-5 and other anti-fraud and anti-manipulation provisions.

The Firms believe rulemaking is not the sole means through which the Commission can effectively address its concerns regarding misrepresentations in the order entry process. If the Commission seeks to promulgate its views on such misrepresentations, the Firms suggest that the Commission employ less formal means of "highlighting" its views. We do not believe the effectiveness of the Commission's message would be undermined or diluted by disseminating the message outside the rulemaking process. The Commission should consider issuing interpretive guidance stating that misrepresentations made with the intention of failing to deliver violate the anti-fraud and anti-manipulation rules.[13] The Commission also might consider using FAQs or a Staff Bulletin to emphasize that failures to deliver that manipulate the price of a security are already prohibited by existing statutes and rules. Additionally, a well-placed public speech by a Commissioner or senior Commission staff member also could be an effective way to "get the word out."

D. Adoption of a New Rule

If the Commission determines that a new rule addressing misrepresentations by sellers is necessary to address failures to deliver, the Firms prefer Proposed Rule 10b-21 to the Long Sale Documentation Proposal. Notwithstanding this preference, the Firms believe that several important changes should be made to Proposed Rule 10b-21 before adoption.

1. Private Right of Action

The Commission should make explicitly clear that the adoption of Proposed Rule 10b-21 does not create a private right of action for violations of the rule -- a point the Commission did not address in the Proposing Release. The promulgation by the Commission of a rule under § 10(b) does not by itself create a private right of action against those who violate the rule where no such right already exists under § 10(b).[14] As

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[13] In 2003, the Commission issued an interpretive release that effectively ended the practice of "married put" transactions. Securities Exchange Act Release No. 48795 (Nov. 17, 2003), 68 FR 65820 (Nov. 21, 2003).

[14] *See Arst v. Stifel, Nicolaus & Co.*, 86 F.3d 973, 977 (10th Cir. 1996) (declining to find private right of action for violation of Rule 10b-10 and stating that "although a private plaintiff may bring suit against violators of § 10(b), a private plaintiff may not bring a suit under an SEC regulation promulgated pursuant to § 10(b) for acts not prohibited by the text of § 10(b)") (citing *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 173 (1994)); *Beaumont v. American Can Co.*, 797 F.2d 79, 84-85 (2d Cir. 1986) (same, finding no private right of action for violations of Rules 10b-6 and 10b-13); *Levitin v. PaineWebber Inc.*, 933 F. Supp. 325, 330 (S.D.N.Y. 1996) (same, no private right of action under Rule 10b-10).

the court found in *In re Short-Sale Antitrust Litigation*, short sales are pervasively regulated by the Commission, and it would interfere with that regulatory scheme to allow courts in private damages actions to produce conflicting guidance, requirements, duties, privileges or standards of conduct.[15] Moreover, there have been repeated instances of meritless litigation in which issuers or investors have sued multiple broker-dealers alleging factually unsupported claims of market-wide conspiracies to conduct naked short selling.[16] Although these cases typically have been dismissed at the pleading stage, the litigation consumes meaningful time and resources. Therefore, the demonstrated risk of abusive litigation is another reason for the Commission not to imply a private right of action.[17] If the Commission determines to adopt Proposed Rule 10b-21, the Firms urge the Commission to make clear that it has not created any private right of action thereunder.

2. Aiding and Abetting

The Proposing Release suggested that Proposed Rule 10b-21, if adopted, would expose broker-dealers to aiding and abetting liability for violations by their customers.[18] Liability for aiding and abetting a securities law violation was not originally set forth in the provisions of the federal securities laws, but was codified in Section 20(e) of the Exchange Act, for Commission enforcement actions only, after the Supreme Court's decision in *Central Bank*.[19] The three elements of aiding and abetting liability under the federal securities laws are: (1) a securities law violation by the primary party, (2) substantial assistance provided to the primary violator by the aider and abettor, and (3) scienter on the part of the aider and abettor.[20] "Substantial assistance" is not precisely defined in the controlling case law, and, even if it were, whether substantial assistance has been provided is a question of fact determined on a case-by-case basis. Furthermore, the cases do not agree whether the scienter requirement is limited to knowledge or is broader and encompasses notions such as reckless disregard. The Firms are concerned

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15 527 F. Supp. 2d 253 (S.D.N.Y. 2007).

16 *See, e.g., id.*; *see also, e.g.*, Quark Fund, LLC et al. v. Bank of America Securities LLC et al., No. 06-2933, 2006 WL 1387600 (S.D.N.Y. July 25, 2006).

17 *See, Stoneridge Inv. Partners, LLC v. Scientific Atlanta, Inc.*, 128 S. Ct. 761, 772 (2008) (declining to recognize expansive "scheme" theory of liability because "extensive discovery and the potential for uncertainty and disruption in a lawsuit allow plaintiffs with weak claims to extort settlements from innocent companies") (citing *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 737 (1975)); *Central Bank.,* 511 U.S. at 189 (stating that "uncertainty and excessive litigation can have ripple effects").

18 Proposing Release, 73 FR at 15379-80 (stating that "as with any rule, broker-dealers could be liable for aiding and abetting a customer's fraud under the proposed rule [in addition to their] liability under Regulation SHO and the general antifraud provisions of the federal securities laws").

19 *Central Bank,* 511 U.S. 164.

20 *Graham v. S.E.C.*, 222 F.3d 994 (D.C. Cir. 2000).

that, if Proposed Rule 10b-21 is adopted, these ambiguities could lead to unnecessary disagreement between broker-dealers on the one hand and the Commission and SRO staff members (and possibly by private plaintiffs' attorneys) on the other.

The Commission should specifically state that reliance by a broker-dealer on a customer representation regarding long/short status or receipt of a locate does not rise to the level of scienter required for aiding and abetting liability. Such an interpretation is particularly important in the context of electronic order entry. As the order placement process continues to become more automated, primarily through use of the FIX messaging protocol, fewer personal interactions occur among buy-side and sell-side trading personnel at the point of order placement. The absence of manual intervention is desired by clients who demand quick executions. To prevent broker-dealers from reasonably relying upon the assurances of their customers would disrupt and significantly slow the order placement process (and, as a consequence, the order execution process). The Firms do not believe that outcome would be beneficial or productive for market participants.

The Commission should make clear that broker-dealers who merely offer direct market access ("DMA") or sponsored access to a customer who violates the new rule will not be liable for aiding and abetting such violation. DMA allows a customer to enter its locate assurances with its broker-dealer through electronic messaging rather than through personal communication. This method of communication should be thought of no differently than any other, and the type of assurances received via FIX protocol no differently than those received by telephone. Imposing aiding and abetting liability in the context of DMA would require broker-dealers to consider evaluating sale orders on an individual basis, considerably slowing the order handling and execution processes. Requiring human intervention or inquiry in the absence of unusual circumstances would significantly curtail the ability of U.S. broker-dealers to successfully offer DMA to customers.

The efficiency of the capital markets depends on broker-dealers being able to accept their customers' assurances generally on matters of credit, capacity, and the like. To the extent the Proposal suggests a duty to inquire in ordinary circumstances, the pace at which the market operates would be significantly affected. Therefore, we urge the Commission to specifically state that a broker-dealer cannot be held to have aided and abetted a violation of Proposed Rule 10b-21 (or any other similar rule) when a broker-dealer relies on a customer representation to execute a trade.[21] Broker-dealers already bear the risk of economic loss if a customer makes a misrepresentation to them in the order entry process, and they should not face the additional burden of aiding and abetting liability.

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[21] The Commission should only impose aiding and abetting liability when a broker-dealer has actual knowledge of, or demonstrates extreme recklessness towards, the customer's misrepresentation. In a circumstance when a rogue broker-dealer employee assists a customer in defrauding the broker-dealer, we do not believe it would be fair or consistent with law to attribute the employee's knowledge to the firm, which is the victim of the fraudulent scheme.

In addition, the Commission should make clear that broker-dealers are permitted to rely upon representations made by other broker-dealers in the course of accepting sale orders. Similarly, the Firms urge the Commission to make clear that a broker-dealer's violation of Regulation SHO, by itself, would not necessarily constitute aiding and abetting a violation of Proposed Rule 10b-21 by a customer.

3. Scienter

The Firms strongly agree with the Commission that, if Proposed Rule 10b-21 were to be adopted, scienter would be a necessary element of a violation as a matter of federal law. As the Supreme Court held in *Aaron v. SEC*, an agency regulation cannot create liability that is broader than the statute pursuant to which the regulation is promulgated.[22] As the Supreme Court further held in *Aaron*, because a violation of Section 10(b) requires a showing of scienter, a violation of any rule promulgated pursuant to Section 10(b) - in that case, Rule 10b-5 - also must require a showing of scienter.[23] Proposed Rule 10b-21 would also be promulgated pursuant to Section 10(b). Under the clear and binding holding of *Aaron*, any violation of Proposed Rule 10b-21 therefore would also require a showing of scienter.

4. Specific Questions Raised in the Proposing Release

Although the Commission asked numerous, discrete questions in the Proposing Release, the Firms have chosen to address only a few of those questions. As a general matter, for the reasons expressed above, the Firms believe that if the Commission were to proceed with Proposed Rule 10b-21, the rule should be narrowly tailored to limit unintended and unwarranted consequences. Consistent with that view, the Firms believe that Proposed Rule 10b-21 should: (i) apply solely to threshold securities, (ii) exclude ETFs and basket securities, (iii) only apply to misrepresentations made to persons accepting/receiving the underlying order, (iv) require a failure to deliver by the seller, (v) permit an ECN to accept a customer's representation absent clear information that the customer is not reliable, and (vi) allow broker-dealers to rely upon the assurances of their customers to satisfy the locate requirement.

We believe the last point is particularly important. As discussed above, the continued ability of broker-dealers to reasonably rely upon assurances of customers to satisfy the locate requirement is critical to the smooth and efficient functioning of the U.S. equity markets. Unless Proposed Rule 10b-21 were modified to eliminate aiding and abetting liability and allow reliance upon customer assurances, the price discovery and liquidity provided through short sales may be constrained. Specifically, some broker-dealers may sharply restrict or discontinue the practice of accepting representations from customers in

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[22] 446 U.S. 680, 691 (1980) (stating that "the Commission's rulemaking power was necessarily limited by the ambit of its statutory authority"); *see also Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1978).

[23] 446 U.S. at 691-95.

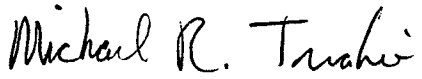
connection with short sales because of liability concerns. In turn, this might lead customers to pursue sales in overseas markets that lack locate requirements, thereby diverting liquidity and price discovery from the U.S. markets.

III. Conclusion

For the reasons set forth above, the Firms believe the Commission should first employ other means to address the targeted illicit conduct rather than immediately adopting Proposed Rule 10b-21. The Commission already can bring an action under Rule 10b-5 and other anti-fraud and anti-manipulation provisions against a person who adversely affects the price of a security by making an untrue statement in connection with a sale of securities and failing to deliver. Moreover, the Commission has effective communication tools at its disposal to highlight in a more immediate fashion the Commission's concerns regarding abusive naked short sales.

The Firms greatly appreciate this opportunity to comment on the Proposal. Representatives of the Firms would be happy to discuss their comments with the Commission or its staff. If you have any questions or would like to discuss this matter with the Firms, please contact me.

Sincerely yours,



Michael R. Trocchio

cc: The Hon. Christopher Cox, Chairman
The Hon. Paul Atkins, Commissioner
The Hon. Kathleen Casey, Commissioner
The Hon. Elisse Walter, Commissioner
Dr. Erik Sirri, Director, Division of Trading and Markets
Robert L.D. Colby, Deputy Director, Division of Trading and Markets
James Brigagliano, Associate Director, Division of Trading and Markets
Josephine Tao, Assistant Director, Division of Trading and Markets
Victoria Crane, Branch Chief, Division of Trading and Markets
Christina Adams, Staff Attorney, Division of Trading and Markets
Todd Freier, Staff Attorney, Division of Trading and Markets
W. Hardy Callcott, Bingham McCutchen LLP