September 26, 2007

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: Release No. 34-56213; File Number S7-19-07
Amendments to Regulation SHO

Ms. Morris:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on the Securities and Exchange Commission's (the "SEC" or "Commission") proposed amendments to Regulation SHO ("Reg SHO" or the "Rule").[2] The Commission is proposing to: (i) require broker-dealers to document the present location of securities being sold in any sale transaction marked as a "long" sale; (ii) eliminate altogether the current options market maker exception from the Reg SHO "close-out" requirement, or alternatively extend the current 13 consecutive settlement day requirement for option market makers to close-out fail to deliver positions.

I. Introduction and Executive Summary

Reg SHO, which has now been effective for over two and a half years, imposed significant changes on the regulation of short sales as well as, more broadly, broker-dealers' clearance and settlement operations. As repeatedly noted by the Commission, overall Reg SHO appears to be having its intended effects without imposing undue impacts on the market,[3] as evidenced by a steadily-declining level of fails-to-deliver, as

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[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

[2] Securities Exchange Act Release No. 56213 (August 7, 2007), 72 FR 45558 (August 14, 2007) ("Proposing Release").

[3] Proposing Release, 72 FR at 45558; *See also* Memorandum from the Commission's Office of Economic Analysis, dated August 21, 2006 (the "OEA Memo").

well as a declining number of Threshold Securities.[4] Equally important, and due in large measure to the market disciplines imposed by Reg SHO, the overall number of fails-to-deliver is also extremely low, with data from the National Securities Clearing Corporation ("NSCC") showing that:

> "99% (by dollar value) of all trades settle on time. Thus, on an average day, approximately 1% (by dollar value) of all trades, including equity, debt and municipal securities fail to settle. The vast majority of these fails are closed out within five days after T+3."[5]

This being the case, the Commission has recently taken other action to address what it perceives to be persistent fails-to-deliver in a small handful of Threshold Securities, namely by eliminating the Reg SHO "Grandfather" provision, which had excepted from the Reg SHO close out requirement any fail-to-deliver positions established prior to a particular security becoming a Threshold Security.[6]

Notwithstanding these positive changes in the market, the Commission is now proposing further amendments which would impose additional and extremely burdensome recordkeeping requirements upon broker-dealers. Specifically, with respect to "long" sales in <u>any</u> security (even very liquid and actively-traded securities), the proposed amendment would require broker-dealers to "document the present location of the security being sold."

SIFMA strongly opposes such long sale documentation requirement on the grounds that it is:

- Impractical and contrary to prior statements by the Commission on the feasibility of documenting such information, and also materially different from prior NASD Rule 3370;

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[4] The following were among the figures cited by OEA: (i) The average daily aggregate fails to deliver declined by 34.0% after the effective date of Regulation SHO; (ii) the average daily number of threshold securities declined by 38.2% from the pre- to post-rule periods; (iii) the average daily fails of threshold securities declined by 52.4%; (iv) the average daily number of threshold securities declined by 29.8% from January 2005 to May 2006; (v) for exchange-listed issues, the average daily number of threshold securities during May 2006 was about 2.18% of all issues; (vi) for all issues traded in the U.S. (including OTCBB and Pink Sheets), the average daily number of threshold securities during May 2006 was about 0.38% of all issues; (vii) a total of 6,223 securities "graduated" from the threshold list since January 10, 2005, representing 4.5 billion shares in initial fails; (viii) only 6 securities have "persisted" on the threshold list since January 10, 2005, and even these 6 securities have seen their fails drop by 68.6%; (ix) 99.2% of the fails that existed on January 3, 2005 are no longer outstanding as of March 31, 2006.

[5] Proposing Release, 72 FR at 45558

[6] Securities Exchange Act Release No. 50103 (July 28, 2004).

- Unnecessary to achieve the Commission's stated goals of reducing fails, and in fact could harm customers by hindering execution quality and market liquidity, as well as by imposing other regulatory restrictions for situations not intended to be covered;
- Extremely burdensome, as it would impose extremely high systems programming costs upon broker-dealers well in excess of the expected costs cited in the Proposing Release, particularly with respect to prime brokerage, delivery versus payment ("DVP") and other custodial arrangements where the seller's securities are often held away from the broker-dealer executing the trade.

In addition to the long sale documentation requirement, SIFMA also has several concerns regarding the proposed amendments to the options market maker exception. In particular, SIFMA is concerned that the proposed elimination of such exception will negatively impact the liquidity of the options market in Threshold Securities, or securities which may be expected to become Threshold Securities. SIFMA opposes the Commission's two proposed alternatives, as they would moreover make compliance with the rule exceedingly difficult from an operational perspective (*i.e.*, due to the need to separately track and close-out fails by options market makers), and would impose upon clearing firm participants burdensome documentation requirements which should more properly be assigned to options market makers relying on such exception.

As stated before, SIFMA strongly supports the overriding objectives of Regulation SHO and commends the SEC staff for seeking to further reduce the number of fails to deliver. As detailed more fully below, we believe that the proposed amendments are fundamentally flawed and are fraught with unintended consequences that, unless modified, will have significant negative impact on market participants. SIFMA's comments, recommendations and responses to questions are provided in greater detail below.

II. Proposed Long Sale Annotation Requirements

A. The Long Sale Documentation Requirement is Impractical and Contrary to the Commission's Prior Statements

SIFMA believes that the long sale documentation requirement is impractical and contradicts prior statements by the Commission recognizing that it "may be difficult for a person to know with certainty at the time of sale that a security will be in the physical possession or control of the broker-dealer prior to settlement." As proposed, the amendments would require broker-dealers, with respect to <u>all</u> sales marked "long," to document the present location of the securities being sold. To the extent the seller is unable to provide the present location of the securities being sold, the SEC notes that the broker-dealer would have reason to believe that the seller is <u>not</u> deemed to own the securities being sold and/or that the securities would not be in its physical possession or

control no later than settlement, and the broker-dealer would thereby need to mark the sale as "short" rather than "long."

Pursuant to Rule 200(g) of Reg SHO, an order can only be marked "long" when the seller owns the security being sold and the security is either in the physical possession or control of the broker-dealer or it is *reasonably expected* that the security will be in the physical possession or control of the broker-dealer no later than settlement date. Such requirement establishes a standard that a broker-dealer must satisfy but does not: (i) mandate a specific order-by-order determination regarding the present location of the securities being sold and whether they will be delivered by settlement date; or (ii) impose an obligation to record such determination on the order ticket. As noted in the Commission's original 2004 Adopting Release on Reg SHO, a conscious decision was made to not require such an order-by-order determination on "long" sales, with the Commission specifically stating in this regard that:

> "As adopted, an order can be marked 'long' when the seller owns the security being sold and the security either is in the physical possession or control of the broker-dealer, or it is reasonably expected that the security will be in the physical possession or control of the broker-dealer no later than settlement. We added the language 'reasonably expected' because we acknowledge that it may be difficult for a person to know with certainty at the time of sale that a security will be in the physical possession or control of the broker-dealer prior to settlement. However, if a person owns the security sold and does not reasonably believe that the security will be in the possession or control of the broker-dealer prior to settlement, the sale should be marked short.'"[7] (Emphasis added)

The notion that broker-dealers should not be required to make an order-by-order determination of the location of securities in connection with "long" sales was further emphasized through the Commission's statements concerning rule 203(a) of Regulation SHO, which provides generally that if a broker-dealer knows or should know that a sale of an equity security is marked "long," the broker-dealer must make delivery when due and cannot use borrowed securities to do so. Rule 203(a) provides an exception from such general prohibition, however, for the situation where a broker-dealer knows or has been *reasonably informed* that the seller owns the security and will deliver it to the broker-dealer prior to the scheduled settlement of the transaction, however the seller fails to do so. In this regard, the Commission had stated in the Adopting Release that:

[7] Securities Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008, 48012 (August 6, 2004).

> "It may be unreasonable for a broker-dealer to treat a sale as long where orders marked 'long' from the same customer repeatedly require borrowed shares for delivery or result in 'fails to deliver.'"[8]

These statements by the Commission therefore recognize that, instead of requiring broker-dealers to make a determination of the present location of securities prior to effecting 'long" sales, broker-dealers should instead have processes and procedures in place that are reasonably designed to perform a post-trade review of long sales and address situations where there may be fails-to-deliver resulting from long sales. As part of their ongoing efforts to comply with the provisions of Rule 200(g) of Reg SHO, as well as other rules, broker-dealers that execute customer and/or proprietary orders have established policies and procedures to ensure that orders are correctly marked "long" or "short."[9] This monitoring enables broker-dealers to track and maintain appropriate records of the frequency with which any particular customer is failing to deliver shares on long sales, and this information may be used by introducing and/or executing brokers to determine the underlying causes for fails on long sales and, if warranted under the circumstances, take remedial action to prevent future fails. These processes fulfill the Commission's goals of reducing the risks of mismarking orders without imposing onerous documentation requirements prior to the execution of each order.

B. Potential Negative Consequences of Proposed Amendment

SIFMA believes that the proposed long sale documentation requirement could result in significant unintended consequences for broker-dealers seeking to execute long sales for their customers. First and foremost, the proposed requirement will unnecessarily delay speed of execution for customer orders, thereby exposing customers to market risk while their order is pending. SIFMA firms believe that, under the current form of the proposed rule, this could occur in at least two situations: (i) a customer's "long" sale order will be delayed while the executing broker is confirming and documenting the present location of the securities being sold and/or (ii) to the extent the broker-dealer is unable to confirm the present location of the customer's securities, and is thus required to mark the order as "short," the sale will be delayed while a determination

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8 *Id.*, 69 FR at 48019, n. 111.

9 For example, pursuant to Exchange Act Rule 15c3-3(m), broker-dealers are required to close out long fails that remain open for 10 business days after settlement by "buying in" the "long" seller, *i.e.*, by purchasing securities of like kind and quantity. In order to comply with this longstanding provision, broker-dealers routinely monitor customer deliveries on long sales and have in place policies and procedures regarding buying-in and allocating buy-ins to the appropriate long sellers. Broker-dealers also may file for extensions of time from the Rule 15c3-3(m) close out requirement by submitting a request to their respective designated examining authorities under Rule 15c3-3(n). The extension filing process requires that broker-dealers track the receipt of shares in connection with long sales because such requests are regularly the subject of examination by self-regulatory organizations.

is made as to whether a "locate" needs to, and can be, obtained for such short sale.[10] Perhaps more significant, concerns could be raised about the impact of such customer "short" sale on the ability for the customer to participate in public offerings of securities, under the recent amendments to Rule 105 of Regulation M.[11]

C. Proposed Amendment Materially Differs from Former Rule 3370

Although it appears that one of the Commission's primary justifications for this proposed requirement is grounded in the belief that it was previously imposed upon broker-dealers, pursuant to prior NASD Rule 3370(b),[12] the proposed long sale documentation requirement is in fact materially different from former Rule 3370, in that it fails to incorporate certain keys exceptions from the prior rule, as well as account for significant developments in the markets since Rule 3370 was first adopted.[13] The net effect of not incorporating such exceptions is that, to the extent such documentation requirement is even feasible, execution of customers' orders could be significantly delayed.

Notably, former Rule 3370 did not impose any specific order documentation requirement prior to acceptance or execution of long sales if: (i) the member had possession of the security; (ii) the customer was long in his account with the member; or (iii) the security was on deposit in good deliverable form with another broker-dealer or bank and instructions were given to that broker-dealer or bank to deliver the securities

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[10] In this regard, while such "short" sale may raise initial concerns for the executing broker, SIFMA believes that, ultimately, any such "short' sales would be entitled to rely on the exception from such requirement set forth in Rule 203(b)(2)(ii), which essentially allows an exception for sales of securities that a person owns, but for which delivery will be delayed.

[11] Securities Exchange Act Release No. 56202 (August 6, 2006), 72 FR 45094 (August 10, 2007). The final rule amendments effectively reformulate Rule 105 into an allocation rule — *i.e.*, subject to certain exceptions, amended Rule 105 generally prohibits any person from acquiring securities in a public offering if such person effected any short sales of the securities that are the subject of the offering during the "restricted period" immediately preceding the pricing of such offering.

[12] The Commission has specifically stated in the Proposing Release that: "Prior to the adoption of Regulation SHO in August 2004, broker-dealers that were members of the NASD were obligated to comply with former NASD Rule 3370(b). Former NASD Rule 3370(b) required a broker-dealer making an affirmative determination that a customer was long to notate on the order ticket at the time an order was taken, the conversation with the customer as to the present location of the securities, whether they were in good deliverable form, and the customer's ability to deliver them to the member within three business days." Proposing Release, 72 FR at 45570.

[13] In this regard, the Commission's proposed amendment would be virtually identical to a previous rule filing submitted by the NASD in 2005 which had been specifically abrogated by the Commission in that it was materially different from the prior form of Rule 3370, and was therefore not a "non-controversial" rule filing entitled to immediate effectiveness. Securities Exchange Act Release No. 52131 (July 27, 2005), 70 FR 44707 (August 3, 2005).

against payment. Only if none of these three conditions existed did former Rule 3370 require a member firm to record on the order ticket the communication with the customer regarding the present location of the securities and whether they would be delivered by settlement date.

In contrast, the Commission's proposed amendment would require all broker-dealers marking all sell orders "long" to document the present location of securities sold, without also incorporating any of the above-referenced exceptions found in prior NASD Rule 3370(b). Such a documentation requirement will have severe market impacts, particularly with respect to sales of securities for broker-dealers' institutional customers, which typically involve the sale of securities on deposit with another broker-dealer (*i.e.*, the customer's prime broker) or bank (*i.e.*, the customer's custodian).[14] Because institutional business is predominantly handled on a delivery-versus-payment ("DVP") basis, the Commission's proposed amendment would now require firms to document the location of securities being sold on virtually all long sale orders placed on behalf of institutional accounts on a DVP basis. This would include sales effected on behalf of registered investment companies that custody their securities at third-party banks, as well as other accounts that custody their securities at one or more prime brokers, but trade through many executing brokers.

By also failing to incorporate the prior exception for the situation where a customer "was long in his account with the member," the proposed amendment will equally impact sales of securities by non-institutional customers. SIFMA believes that, in order to avoid unintended consequences, including delayed execution, to retail customers, the proposed documentation requirement should similarly incorporate an exception where the customer is long in his account with a broker-dealer, including sales of securities carried long in a customer's margin account which have been rehypothecated pursuant to a margin account agreement.[15]

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[14] These arrangements enable customers to execute transactions with a variety of broker-dealers without interfering with existing credit or custodial relationships.

[15] Generally, upon signing a margin account agreement, a customer authorizes his or her broker-dealer to re-pledge or rehypothecate securities with a market value equal to 140% of the net debit in the customer's margin account. Broker-dealers rely on this authorization to use customer securities in the ordinary course of business, such as to satisfy delivery obligations of other customers or the firm's proprietary sales, to fund customers' margin debit balances, or to lend to other market participants. Broker-dealers' use of customer margin securities represents an important source of funding and securities market liquidity. Should there not be an exception for the situation where the customer is long in his account with the broker-dealer, including for rehypothecated securities, this could not only impact the ability of broker-dealers to fund their clients' positions, but also result in decreased liquidity in the stock loan market and the market as a whole. Decreased liquidity in the stock loan market could actually lead to a situation where there are a greater number of overall fails-to-deliver in the market, due to the inability of broker-dealers to lend securities to other market participants to cover such fails. Interestingly, such a result would seem to be directly in contrast to the SEC's motivations behind the proposed documentation requirement, *i.e.,* reducing fails in connection with long sales.

D. Costs of the Proposed Amendment Clearly Outweigh the Benefits

The net effect of the proposed long sale documentation requirement is that it would impose extreme costs which would severely outweigh any benefits that might be derived. These would not only include substantial costs to broker-dealers and their customers associated with revamping their front-end order systems, but would also include severe costs to customers, namely due to delayed execution of their long sale orders.

1. Substantial Systems Programming Costs

Requiring firms to establish a process to obtain and document the required information at the point of order entry would impose severe administrative burdens on broker-dealers, in essence requiring most broker-dealer's front-end systems to be substantially modified to capture this information. As the Commission is aware, the vast majority of orders that broker-dealers receive from their customers, especially institutional customers, are delivered electronically. Requiring additional order fields requires that the: (1) sender can record and transmit the relevant information; (2) inputting system can capture the additional information; (3) the recipient of the order "knows" how to capture that information; and (4) the recipient can process that additional information properly. Direct Market Access ("DMA") order flow is received by firms through a vast network of systems that communicate with each other utilizing a standard messaging format known as the FIX protocol, which assigns standard definitions to data fields commonly utilized in electronic transmissions throughout the financial industry, and assigns undefined values to data fields which can be customized by users. In order for two systems to communicate utilizing the FIX protocol, both the recipient and sender have to conform their systems so that each system "knows" what standard fields are going to be sent to it, and both systems have to further agree on the definitions for undefined fields. Assigning a new definition to a field requires a new FIX version, and generally full implementation of a FIX version has a 3-4 year cycle.[16]

With regards to the new proposed requirement, even assuming that the existing FIX short sale locate field can accommodate the location of a long position, it will not recognize multiple values. Therefore, if a long position is held across more than one custodian, broker's systems will not be able to recognize more than one value in the locate field. If multiple custodians are to be recognized, multiple locate fields will need to be defined. Additionally, the system on which the long sale is entered will need to modify their Graphic User Interface ("GUI"), implement prompts that prevent the order from being sent without this information and map the locate data to the appropriate FIX field. Further, the receiving system needs to "know" to look for the locate information on

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[16] The latest FIX version (4.4) has been in the process of implementation for 2 years.

a long sale and retain it in a database. Lastly, there is no ability for a broker to "self-locate" like there is in the case of short sales and thus, while some order input systems may have been able to rely on the broker seeking a locate in the past, those systems may now need substantial development in order to continue to route orders without manual intervention.

Instituting systems changes to incorporate the proposed documentation requirement would be further complicated by the fact that broker-dealers' institutional clients typically route order flow using independently-operated execution management systems. Therefore, compliance with the proposed amendment would require firms to change numerous systems used by clients, some of which may be proprietary and some of which may be provided by third-party vendors.

Typically, the message protocols for order delivery are not structured to support settlement and delivery instructions. Rather, such information is almost universally handled in the back office processes each evening or in subsequent days leading up to settlement, and is generally based on standing instructions as to the location from/to which funds and securities are to be delivered, as opposed to any order-by-order references to that information at the front end of the order entry process. There is long-standing precedent for allowing broker-dealers to enter into such bona-fide agreements with their customers regarding the marking of orders.[17]

2. *The Commission's Cost Estimates are Flawed*

SIFMA firmly believes that the Commission has drastically underestimated the systems costs that would be associated with the proposed long sale documentation requirements. Specifically, the Commission has provided in the Proposing Release the following cost estimates: (i) it would take a registered broker-dealer approximately 0.5 seconds to document the present location of the securities being sold; (ii) on average, instituting programming to automate the documentation process, including reprogramming systems, integrating systems, and updating front-end software, would take approximately 16 hours and cost $1,072 per broker-dealer, for a total across the industry of $6,226,176.

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[17] The use of contractual agreements with customers regarding the marking of orders has existed ever since short sale regulations were initially enacted in the 1930's. In particular, in 1938 the SEC confirmed a New York Stock Exchange interpretation that endorsed the use of contractual agreements, "[t]o obviate the necessity of hurriedly obtaining the information specified in rule [10A-2], it is advisable for the member when he receives the order also to obtain information from the seller as to the practicability of then delivering the security. <u>As a method of obtaining such information with respect to an order to sell, a member (including any floor broker) may enter into any bona-fide written agreement with his customer that the customer, when placing 'short' sell orders, will designate them as such, and that the designation of a sell order as 'long' is a representation by the customer to the member that the customer owns the security, that it is then impracticable to deliver the security to such member and that the customer will deliver it as soon as is possible without undue inconvenience or expense.</u>" (emphasis added) Securities Exchange Act Release No. 1571 (February 5, 1938).

These figures are extremely unrealistic. With respect to the time necessary to document the present location of the securities being sold, to the extent this requirement is feasible at all, it could certainly be expected to take longer than 0.5 second, and, in turn, would negatively impact speed of client executions. With respect to programming costs, as noted above, most firms would essentially need to rebuild their front-end systems to capture the required information for long sales – as most firms have multiple front-end systems (with the larger firms having upwards of 40 to 50 such systems), SIFMA believes that instituting such programming changes could actually take approximately 12 months, with costs ranging from approximately $200,000 for some broker-dealers to over $1,000,000 for others. Therefore, using the SEC's calculation (*i.e.*, based on the fact that there are 5,808 registered broker-dealers),[18] costs would range from approximately $1,161,600,000 to over $5,808,000,000 across the industry as a whole. This figure does not even take into account additional costs associated with surveiling for compliance with the documentation requirement.

3. Costs Outweigh any Benefits to be Received

Moreover, despite the Commission's statements to the contrary, SIFMA strongly believes that the substantial costs associated with these changes would significantly outweigh any benefits which might be derived. SIFMA has provided responses below to what appear to be the primary alleged benefits of the documentation requirement, as stated by the Commission:

- *SEC Stated Benefit:* The documentation requirement could reduce the number of fails because, "after making inquiry into the present location of the securities being sold, a broker-dealer would know whether or not it needed to obtain securities for delivery."[19]

- *SIFMA Response:* The Commission's stated benefit fails to take into account the operation of the continuous net settlement system ("CNS"), which as the Commission is aware essentially nets all settling purchase and sale transactions (long and short) in particular securities effected by a participant broker-dealer, which are netted against each other and netted against the prior day's closing positions (if any) to compute the participant broker-dealer's net settlement commitment (CNS position) each day.[20] As such, a broker-dealer would not in fact "know whether or not it needed to obtain securities for delivery" when executing each sale transaction, but would rather instead

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[18] Proposing Release, 72 FR at 45574-45575.

[19] Proposing Release, 72 FR at 45574.

[20] To effect settlement of a participant broker-dealer's CNS delivery obligation, existing securities positions are transferred from such participant's account at DTC to NSCC's account to cover the participant broker-dealer's delivery obligation to CNS.

need to consider its bulk settlement obligation to CNS. Moreover, although the Commission is citing a desire to "reduce the number of fails," SIFMA believes this is a solution looking for a problem, due to the Commission's other statements on the extremely low level of fails overall.[21] Importantly, the proposed long sale documentation requirement would apply to all securities, even very actively-traded and liquid securities which may generally have little to no fails whatsoever.

- *SEC Stated Benefit*: The documentation requirement would aid in ensuring the correct marking of sell orders, and assist the SROs in examining for compliance – any seller that is unable to provide the present location of the securities being sold would be required to mark the sale "short," and comply with all applicable short sale regulations, including the Reg SHO "locate" requirement, as well as Rule 105 of Regulation M.[22]

- *SIFMA Response:* As noted in further detail above, the proposed documentation requirement simply may not be practicable in a number of situations, which could thus mean that the customer's sale of the position he/she owns could need to be marked "short." If such "short" sales were required to comply with the "locate" requirement of Reg SHO, this could needlessly delay execution of the customer's sale of securities.[23] Moreover, such "short" marking could raise questions/concerns about the ability for the customer to participate in a registered public offering of stock, pursuant to the requirements of new Rule 105 of Regulation M, even in situations where the customer was only effecting a sale (or even a partial sale) of a position the customer owned in the security that was the subject of the offering. As described above, firms already have processes and procedures in place for post-trade reviews of long sales reasonably designed to monitor for and address fails to deliver, and have additional procedures in place to monitor for situations where a customer actually effected a short sale without obtaining a locate, or established a short position through a long sale during the Rule 105 "restricted period."[24] As described below, there have also been significant efforts between the Commission and the industry to develop, in the prime brokerage context, post-trade reviews of long sales, which will assist the compliance efforts of both firms and SROs.

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[21] *See, supra* n. 5.

[22] Proposing Release, 72 FR at 45574.

[23] Although SIFMA believes that, ultimately, any such "short' sales would be entitled to rely on the exception from such requirement set forth in Rule 203(b)(2)(ii), which essentially allows an exception for sales of securities that a person owns, but for which delivery will be delayed.

[24] Moreover, while the Commission and SROs might have previously been concerned about sales being marked "long" to avoid short sale "price test" restrictions, any such concerns have been removed though the elimination of the "tick" and "bid" tests.

In conclusion, SIFMA believes it is patently clear that any perceived benefits associated with the proposed documentation are far outweighed by the substantial associated costs, and the fact that the Commission's perceived benefits are already addressed through the processes and procedures broker-dealers have already developed to comply with Reg SHO and related rules.

E. Impact on Prime Brokerage and Custodial Arrangements

The proposed long sale documentation requirement would also impose real problems in situations where a broker-dealer is executing a long sale for a customer whose securities positions are held away, such as in prime brokerage and other custodial arrangements. In addition to the significant systems costs that would be associated with requiring such information to be submitted by customers with their orders, as described above, SIFMA believes that any such mismarking concerns can be more appropriately addressed through post-trade monitoring and communications between the entity that is holding the position, and the broker-dealer executing the trade. In this regard, as the Commission is aware, SIFMA firms have worked with the staff of the SEC and the SROs over the course of the last several years to modify the 1994 Prime Broker No-Action Letter to account for developments brought about by Regulation SHO. Among other things, the proposed modifications are designed to enhance communications between prime brokers and executing brokers with respect to order marking, to help ensure that the customer is providing accurate information to the executing broker. To the extent it may be determined that a customer is mismarking sales, the proposed modifications require the prime broker to provide such information to the executing broker, so that appropriate action may be taken. SIFMA firms have been anxiously awaiting the issuance of such letter and the guidance provided therein on this issue, as well as other issues related to Reg SHO.[25]

F. Exceptions from the Long Sale Documentation Requirement

As described in detail above, SIFMA firms strongly believe the proposed long sale documentation requirement is unnecessary, and would have a number of unintended consequences. If, however, the Commission still believes it necessary to impose a long sale documentation requirement, such a rule would need to incorporate the exceptions previously identified in former NASD Rule 3370, with some modifications to reflect

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[25] It is interesting to note that the proposed documentation requirements for "long" sales would likely be even more burdensome than the requirements imposed on executing brokers with respect to "short" sales received from customers. Specifically, as the Commission has acknowledged, although an executing broker has the responsibility to comply with the Reg SHO "locate" requirement, it is able to reasonably rely on assurances from the customer that a locate has been obtained at another source, such as the customer's prime broker. This being the case, the executing broker *does* have the option of obtaining the locate itself on behalf of the customer. With respect to "long" sale orders received from customers, executing brokers would not have this option, but would rather be required to document the present location of the customer's securities.

developments in the markets, including increased electronic order flow, and the increased use of prime brokerage arrangements. Specifically, SIFMA believes that it would be necessary to include exceptions from the long sale documentation requirement to cover *at least* the following situations:

- The broker-dealer has possession of the customer's security.
- The customer is long in his account with the broker-dealer.
- The broker-dealer has information regarding the customer's custodial relationship, including but not limited to where securities are held with another broker-dealer through a prime brokerage arrangement established pursuant to the Commission's 1994 Prime Broker No-Action Letter (including any subsequent amendments thereto), or where securities are held with any organization subject to state or federal banking regulations and that instructions have been forwarded to that depository to deliver the securities against payment.

III. Proposed Amendment to the Option Market Maker Exception

A. Proposed Amendments

The SEC has proposed to eliminate in its entirety the exception from the Reg SHO close-out requirement for any fail-to-deliver position in a Threshold Security that is attributable to an options market maker effecting short sales to establish or maintain a hedge on options positions that were created before the security became a Threshold Security.[26] The SEC has proposed two complex alternatives to the complete elimination of the options market maker exception, which would provide a slightly longer period of time to close out fail to deliver positions than the 13 consecutive settlement day period required under Rule 203(b)(3).[27]

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[26] The proposed amendment would include a one-time phase-in period, which would require that any previously-excepted fail-to-deliver position in a Threshold Security on the effective date of the amendment, including any adjustments to such fail-to-deliver position, would be required to be closed-out within 35 consecutive settlement days from the effective date of the amendment.

[27] The first alternative would require a clearing firm participant that has a fail to deliver position in a Threshold Security resulting from a short sale by a registered options marker maker to establish or maintain a hedge on an options series within a portfolio that was created before the security became a Threshold Security to close out the entire fail to deliver position, including any adjustments to that position, within 35 consecutive settlement days of the security becoming a Threshold Security. The second alternative would require a clearing firm participant that has a fail to deliver position in a Threshold Security resulting from a short sale by a registered options market maker to establish or maintain a hedge on any options series in a portfolio that was created before the security became a Threshold Security to close out the entire fail to deliver position, including any adjustments to that position, within the <u>earlier</u> of: (a) 35 consecutive settlement days from the date on which the security became a Threshold Security, or (b) 13 consecutive settlement days from the last date on which all options series within the portfolio that were created before the security became a Threshold Security expire or are liquidated.

The proposed alternatives would require that options market makers and clearing firm participants document that any fails to deliver in Threshold Securities that have not been closed out within the 13 consecutive settlement days required by Rule 203(b)(3) are eligible for the options market maker exception. The SEC has stated that such documentation could identify, among other things: (i) when the series being hedged was created, (ii) when the underlying security became a Threshold Security, and (iii) the age of the fail to deliver position that is not being closed out.[28]

B. SIFMA Supports Retaining the Current Options Market Maker Exception and Opposes the Proposed Alternatives

While complete consensus among SIFMA firms is not possible, many firms oppose the complete elimination of the options market maker exception, in that it is believed such action could have drastic impacts on the liquidity of the options market for Threshold Securities, and other securities which may become Threshold Securities in the future. SIFMA firms generally support the options market maker exception being retained in its current form, however oppose the Commission's proposed alternatives, in that such alternatives would be unworkable from an operational perspective, and would impose extremely burdensome documentation requirements on clearing firms, in addition to options market makers relying on the proposed exception.

Specifically, the proposed alternatives would require clearing firm participants to still track and close out fail-to-deliver positions in Threshold Securities that remained for 13 consecutive settlement days, but also require clearing firm participants and options market makers to separately track, and close out, fail-to-deliver positions caused by options market makers that remained for a period greater than 13 consecutive settlement days (*e.g.*, 35 consecutive settlement days). By and large, SIFMA firms believe that instituting and maintaining two separate tracking systems would be unmanageable.

What is more, the proposed alternatives would also impose onerous documentation requirements on clearing firm participants, in addition to options market makers, to prove proper reliance on the exception. Clearing firms feel strongly that responsibility for determining compliance with the options market maker exception properly rests with such registered options market makers, rather than a firm which is merely clearing the market maker's trades.[29] Any such documentation requirements

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[28] The SEC has stated its belief that such a documentation requirement would enable the SEC and the SROs to monitor more effectively whether or not the option market maker exception is being applied correctly, as well as provide a record that would aid surveillance for compliance with the options market maker exception.

[29] Market makers, not their clearing firms, have the information necessary to determine whether their activities are covered by the options market maker exception. If responsibility for compliance were to rest with the clearing firm, then in effect the clearing firm could need to understand, among other things, the market maker's strategy and hedging positions, including its view of factors such as options volatility used by market makers in making hedging decisions. In light of this, it would simply not be practicable, or

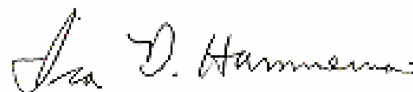
should therefore be the responsibility of the specific market maker who is claiming reliance on the exception.

IV. Conclusion

SIFMA respectfully urges the careful consideration of the above comments and questions regarding the Proposing Release, as it believes that the proposed amendments and other items raised by the Commission in the Proposing Release do not appear to be in the best interests of the U.S. capital markets, and would create additional risks and impose substantial unnecessary costs upon SIFMA firms and their customers that would be far greater than the potential benefits that might be received.

If you have any questions or require additional information, please do not hesitate to contact the undersigned at 202-434-8400 or Amal Aly, SIFMA Vice President and Associate General Counsel, at 212-608-1500. Thank you for your attention to this request.

Sincerely,



Ira D. Hammerman
SIFMA Senior Managing Director
and General Counsel

cc: The Hon. Christopher Cox, Chairman
The Hon. Paul Atkins, Commissioner
The Hon. Annette Nazareth, Commissioner
The Hon. Kathleen Casey, Commissioner
Dr. Erik Sirri, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation
James A. Brigagliano, Associate Director, Division of Market Regulation
Josephine Tao, Assistant Director, Division of Market Regulation
Victoria Crane, Branch Chief, Division of Market Regulation
Kevin J. Campion, Sidley Austin LLP

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possible, for a clearing firm to review every single trade executed by each of the potentially numerous market makers for which it clears to ensure such activity was consistent with bona-fide market making activity, and hedging pre-existing options positions. Clearing firms should instead be able to reasonably rely upon a firm's designation as a market maker by the AMEX, CBOE, and/or another exchange in determining whether the market maker's short position was bona-fide hedging its options exposure.