November 25, 2008

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

Re: Release No. 34-58773, File No. S7-30-08, Amendments to Regulation SHO (Interim Final Temporary Rule)

Dear Ms. Harmon:

EWT, LLC ("EWT") appreciates the opportunity to provide the Securities and Exchange Commission (the "Commission") with comments on interim final temporary Rule 204T ("Rule 204T" or the "Rule") of Regulation SHO under the Securities Exchange Act of 1934 (the "Exchange Act").[1]

EWT is a proprietary, self-clearing broker-dealer registered with the Commission under Section 15 of the Exchange Act. EWT is a member of the Financial Industry Regulatory Authority ("FINRA"), the New York Stock Exchange, NASDAQ and, together with its affiliates, operates across more than 25 other exchanges and market centers around the world. Engaging in direction-neutral algorithmic trading and using proprietary trade execution technology, EWT has a significant market share in several asset classes and is a major, active participant in the equities markets. EWT does not engage in customer transactions and derives its income from its proprietary market making activities. As a market maker, EWT provides significant liquidity to the marketplace and investors. It does not seek to profit from "bets" on downward market movements, through short sales or otherwise.

As an active participant in the equities market, EWT believes that curbing threats to fair and orderly markets and maintaining investor confidence are of paramount importance. Accordingly, EWT strongly supports the efforts of the Commission and its staff to address concerns about the spreading of false rumors, abusive "naked" short selling,[2] and other manipulative conduct.

1 Release No. 34-58773 (Oct. 14, 2008), 73 Fed. Reg. 61706 (Oct. 17, 2008) (the "Adopting Release"). The Rule was originally adopted by the Commission as an emergency order in September. See Release No. 34-58572 (Sept. 17, 2008), 73 Fed. Reg. 54875 (Sept. 23, 2008) (the "Order").

2 An "abusive 'naked' short sale" is not defined in Rule 204T or the Adopting Release, but we understand it to be a short sale made without having stock available for delivery (or locating such stock) and then intentionally failing to deliver stock within the standard three-day settlement cycle. The Commission has

In our comments below, we thus focus solely on certain technical aspects of Rule 204T that, due to their impact on the securities lending market, appear to have given rise to significant unintended consequences, including to holders of long positions, and to have contributed to decreased financing liquidity and increased market volatility. At a time when the credit crisis has caused unprecedented contractions in traditional lending channels, these technical features of Rule 204T have, in our view, inadvertently produced similar pressures reducing the availability of credit in the securities lending market. In particular, Rule 204T creates significant disincentives to engaging in securities lending activity, especially given the potential exposure to substantial penalties under the Rule. These disincentives have, we believe, substantially reduced market makers' ability to provide liquidity, contributing to last-minute market swings and wider bid/offer spreads. These developments have thus harmed the efficient functioning of markets and imposed considerable costs on the individual investor.

I. Securities Lending and the Market Impact of Rule 204T

Securities lending plays a central role in modern financial markets, not only by assisting in assuring timely delivery of securities on settlement date but also by providing increased market liquidity and a source of financing for long positions. Rule 204T, while intended to curb abusive "naked" short sales and other manipulative conduct, also contains technical provisions – applicable to legitimate short sales and, indeed, even long sales – that have created practical impediments to the effective operation of the securities lending market and have negatively impacted legitimate market activities. In particular, the timing and close-out requirements of the Rule create significant disincentives for holders of long positions to lend their securities, because of the risk that the securities will not be returned by a counterparty sufficiently promptly to avoid economic or regulatory penalties to the lender.

A. Role of Securities Lending

As the Commission is aware, securities lending transactions serve multiple important functions in the financial markets. Participants in the securities lending market include broker-dealers, banks, mutual funds and a wide range of institutional investors.[3] As of June 2008, the outstanding balance of securities loan transactions was approximately $500 billion, providing a source of liquidity for the financial industry.

---

previously provided guidance in this regard in Release No. 34-56212 (Aug. 7, 2007), 72 Fed. Reg. 45544 (Aug. 14, 2007), and Release No. 34-54154 (July 14, 2006), 71 Fed. Reg. 41710 (July 21, 2006).

3 We note that securities lending is a critical component of the business of not only broker-dealers but also many large institutions, particularly pension funds, insurance funds and mutual funds. For instance, until recently AIG's securities lending business totaled over $180 billion in assets; the deterioration of that business led the Federal Reserve Bank of New York to open a $37.8 billion lending arrangement with AIG in early October. See Peter Adamczyk, Securities Lending – A Growing Investment Strategy, AIG Global Investment Group (Apr. 2006) (describing AIG's securities lending business); and Barry Meier and Mary Williams Walsh, A.I.G. to Get Additional $37.8 Billion, N.Y. Times, Oct. 9, 2008, at B1 (describing the Federal Reserve's $37.8 billion supplemental lending arrangement with AIG).

At the most basic level, securities lending allows market participants to meet delivery obligations in situations in which they do not have possession of securities on the settlement date, including where the securities have not been delivered by a trading counterparty. The availability of securities for loan has thus traditionally reduced the incidence of fails and enhanced market liquidity.

Perhaps more importantly, given current conditions in the credit markets, securities lending also constitutes an important source of financing. When holders of long positions in securities lend their securities, they generally obtain cash or other liquid collateral that permits them to finance those long positions. In this way, securities lending provides a flexible and economical alternative or supplement to bank lines of credit, which have become increasingly difficult to obtain.[4] Without this alternative, broker-dealers tend to concentrate their financing with a single clearing bank and may be forced to curtail operations or reduce their long positions to maintain adequate capital reserves.[5]

B. Operational Impediments

The practical operation of the securities lending market depends upon the ability of borrowers and lenders to effectuate recalls and returns of loaned securities consistent with cash market settlement time frames and lender financing requirements. The technical requirements of Rule 204T, as currently drafted, generate impediments to this process that create substantial disincentives to the use of securities lending transactions.

When the holder of a long position sells securities that have been financed through a securities loan, the holder generally must recall the securities from the borrower to satisfy the holder's delivery obligation. This recall typically occurs in a fashion designed to assure that the securities are returned on the settlement date for the sales transaction ("S"). If the securities are returned before that date, the holder has little choice but to obtain alternative, and potentially inferior, financing pending settlement; if the securities are not returned by that date, the holder of the securities cannot make delivery on its cash market transaction.

In the event that the securities are not returned to the lender at the close of business on the settlement date, the lender may initiate a buy-in (i.e., close-out) process designed to obtain the securities as promptly as practicable. Consistent with the settlement cycle for U.S. markets, this buy-in process is intended to result in delivery of the securities after three business days ("S+3") (i.e., the shortest time for obtaining them through a purchase in the open market).

---

4 We note that securities lending financing typically provides cash value equivalent to 100% of the value of the securities, while lines of credit provided by banks – when available – are typically limited to 50-80% of the value of the securities.

5 Our analysis of the FOCUS reports of securities lending counterparties indicates that, in June, 95% of the securities used in collateralized financing were used for direct securities lending, and only 5% were used for bank loan financing. In September (the most recent data available), the percentage of securities used in collateralized financing for direct securities lending dropped dramatically to 35%, and the percentage used for bank loans jumped to 65%. As noted below in Part I.C, securities lending has also declined overall.

In practical terms, therefore, when a borrower fails to return securities on the settlement date, a lender cannot complete the buy-in process more quickly than three full days after the settlement date, or until the close of the Depository Trust Company ("DTC") settlement window on S+3.[6] However, the close-out provision of Rule 204T(a)(1) imposes an obligation on market participants to close out a fail to deliver position resulting from a long sale (a "long fail") no later than market open on S+3.[7] Thus, the lender has no opportunity to execute a buy-in prior to the expiration of the period specified in Rule 204T(a) and the imposition of penalties under Rule 204T(b).

This inconsistency results in substantial economic and regulatory penalties to the lender. Since Rule 204T(a)(1)'s close-out period of S+3 does not permit sufficient time for either a borrower responding to a recall notice to replace securities through a purchase in the open market or a lender to execute a buy-in, broker-dealers are faced with an undesirable choice: lending securities at a substantial risk of non-compliance due to events outside of their control, or avoiding securities lending as a source of financing liquidity in order to ensure compliance.[8]

A further constraint arises out of the Rule's requirement that a broker-dealer close out a long fail only by a purchase of the securities – not by borrowing the securities to make delivery.[9] Allowing market participants to borrow securities for their Rule 204T obligations would provide them a powerful tool to close out a long fail immediately, unlike a buy-in, which requires three days for settlement. The buy-in process is unnecessarily long and expensive, and exposes market participants to unwarranted price risk, undermining confidence in securities lending markets.[10] Mandated buy-ins also may limit the ability of market participants to engage in term securities loans, which can provide a stabilizing foundation for a financing portfolio during periods of volatility in the credit markets. Without the option to borrow securities to close out a long fail, a lender may be forced to prematurely terminate a term loan with a buy-in, when a new borrow would have sufficed in both meeting the lender's delivery obligations and

---

6 As noted above, if a lender sought to address this timing issue by recalling the securities earlier than the settlement date, it would risk loss of its financing as a result of the potential return of the securities prior to the settlement date for its long sale. This risk effectively defeats the purpose of initiating a securities lending transaction in the first place.

7 See Rule 204T(a)(1).

8 A parallel timing problem also arises in connection with market maker short sales under the Rule.

9 We note that a market participant with a long fail on S who borrows the securities on S+1 not only fails to satisfy the Rule 204T(a)(1) close-out requirement, but also may be trapped in the Rule 204T(b) "penalty box." As the Rule is currently drafted, the market participant cannot escape the "penalty box" until it has closed out the long fail by purchasing additional securities, but the fail no longer exists due to the delivery of the borrowed securities.

10 Buy-ins are executed at a time and price of the lender's choosing, exposing the borrower to unknown costs and potentially market risk on the bought-in position. Buy-in costs are presumably passed on to investors either directly (e.g., trades are broken or reversed) or indirectly (e.g., the participant absorbs the cost of the buy-in and any transactions required to restore the customer's positions).

preserving the term loan. We note that the average term of securities loans has declined over 25% since the enactment of the Order and the trend appears to be continuing.

We also note that securities loan transactions rarely, if ever, occur for notional values of less than one million dollars, making it exceedingly difficult for market participants to borrow small quantities of securities, whether to satisfy Rule 204T or otherwise. This de facto floor is simply a matter of economics: if a typical securities lender expects to earn 10-50 basis points on each transaction, this revenue will equate to \$3 to \$14 per day for a million-dollar loan, an amount which is unlikely to cover the costs of processing the transaction. As a result, since Rule 204T contains no de minimis exemption, any market participant with a need to borrow small positions will experience difficulty in complying with the Rule.

Finally, while the Adopting Release notes that "human or mechanical errors or processing delays" happen and can result in a legitimate fail, Rule 204T leaves no room for such errors.[11] The few hours between the delivery of overnight reports of the prior day's activity and the open of the market provide scant time for accurate reconciliation of positions and activities, a task that typically takes back-office staff a full day. Recent surges in volumes and related failures of systems across the industry have only exacerbated the situation. Even if a market participant takes a conservative approach to Rule 204T and issues buy-ins based on an incomplete reconciliation, the inadequate time for a full review before market open means that actual fails may be missed and unintended violations may occur.

C. Impact on the Market

The technical timing and close-out requirements of Rule 204T thus create strong disincentives to loan securities or take long positions, which in turn appear to have led to an increase in borrowing costs and a decrease in market efficiency. Broker-dealers' concerns regarding their ability to finance their positions and still satisfy the requirements of the Rule have, in our view, been a significant factor in recent dramatic declines in the volume of securities lending. While recent market turmoil makes it difficult to isolate any single cause, it is notable that since the Order, the balance of outstanding loans has dropped approximately 36%, measured by quantity of securities, and approximately 53%, measured by value.[12] We have observed a substantial decline in securities lending balances at our direct counterparties, increased reliance on alternate and more expensive credit facilities, and higher costs of financing, which may be ultimately passed on to customers (including individual investors).

Not only does this substantial reduction in financing liquidity in the securities lending market impact the ability for broker-dealers to borrow securities to meet delivery

---

11 Adopting Release at 61713. We note that the Adopting Release estimates 9809 new fails occur each day. Although the intentional fails targeted by Rule 204T account for some fraction of this number, our experience and judgment suggest that the greater share of these fails are not due to malfeasance, but simply due to human or mechanical errors or processing delays.

12 Securities Borrowing & Lending Summary for the Week through October 31, 2008, SunGard Astec Analytics.

obligations, but it also leads to an increase in borrowing costs and jeopardizes the ability of broker-dealers to continue financing their long positions. Without the ability to rely on securities lending, broker-dealers cannot effectively finance long positions that could otherwise help to counteract the "sudden and unexplained declines in the prices of equity securities" described in the Adopting Release.[13] Broker-dealers unable to finance long positions held on margin by customers may be forced to close out customer positions, which would put further pressure on long positions.[14] In this respect, Rule 204T thus seems likely to have the unintended consequence of undermining one of the very goals it was adopted to serve.[15]

Moreover, the Rule impedes the ability of market makers "to facilitate customer orders in a fast moving market"[16] by limiting their ability to rely on the securities lending market, an essential source of financing for their activities.[17] To perform their functions, market makers must be willing to assume risk on both sides of the market throughout the trading day, and, consequently, hold positions for brief periods of time. If they cannot rely on the securities lending market to finance their positions, their ability to take on this risk will be substantially reduced. In addition, because market makers engaging in securities lending activities run a serious risk of being subject to the trading restrictions of Rule 204T(b), they may be further restricted in their ability to make markets for the public.

The impact of market makers' reduced ability to rely on the securities lending market becomes particularly pronounced toward the end of the trading day. While a market maker generally carries a small position, if any, in a given security, it is not uncommon for it to take on a larger position at the market close, due to the facilitation of customer orders during market movements at that time. Under ordinary circumstances, market makers can finance such positions through the securities lending market; in the current environment, market makers are

---

13 Adopting Release at 61707.

14 Broker-dealers with access to substantial lines of bank financing may avoid close-outs, but they will likely increase margin financing rates and margin deposit amounts for customers, thereby increasing borrowing costs to individual investors. We also note that broker-dealers' increased reliance on bank financing risks concentrating their credit counterparty exposures at a time when counterparty risk is particularly acute. This situation also limits flexibility in the financial system, as it does not allow broker-dealers with surplus cash from lending it to other broker-dealers with cash financing needs. The latter broker-dealers generally must seek liquidity support from their settlement banks, which may in turn be liquidity constrained.

15 Rule 204T also undermines efforts by the Federal Reserve and others to stabilize the credit markets. Indeed, the sharp decline in financing liquidity following the Order puts broker-dealers in the position of having to rely more extensively on measures by the Federal Reserve to add liquidity to the short-term credit markets via overnight and term lending facilities, as well as associated efforts by the Treasury Department and the Federal Deposit Insurance Company to bolster the health of financial institutions via capital injections and debt guarantees, respectively.

16 Adopting Release at 61715.

17 Although the Rule contains certain necessary special provisions applicable to market makers, those provisions do not adequately address the operational timing issues described above. Regardless, even a more comprehensive exemption for market makers would not sufficiently address these issues, as counterparties would remain unwilling to loan to market makers so long as the timing difficulties persist.

not able to rely on such financing without risking non-compliance with Rule 204T(a) and thereby incurring penalties under Rule 204T(b). Consequently, market makers have hesitated to absorb large positions at market close, with a commensurate reduction in the depth and quality of liquidity as market makers attempt to curtail the risk of ending the day with an unwanted – and potentially unfinanceable – position. The result of this reduced liquidity has been a marked increase in volatility around the market close since the effective date of the Commission's Order. The significant spike in volatility has been widely noted in the press – with an average swing during the last half-hour of trading of over 258 points in the Dow Jones industrial average during the month of October.[18] These last-minute market movements have drawn widespread concern[19] and, of course, are inconsistent with the Commission's "goal of preventing substantial disruption in the securities markets."[20]

II. Recommendations

In light of the concerns described above, we urge the Commission to review fully the implications of the Rule and whether it is the most effective method of achieving the important objective of creating disincentives against the circulation of unfounded rumors regarding the stability of financial institutions, abusive "naked" short selling, and manipulation of the prices of securities. In any event, we consider it essential for the Commission to make modifications to Rule 204T to address its unintended consequences on an urgent and expeditious basis. We respectfully request that the Commission consider, in particular, each of the modifications we suggest below, which we believe preserve the central objectives advanced by the Commission and which we have ranked in order of importance:

(1) The Commission should either (a) create an exception under Rule 204T(a)(1) for fails to deliver where the securities are loaned but have been recalled or (b) confirm that the issuance of a bona fide loan recall notice is a valid form of close-out for a fail under Rule 204T(a)(1). This change would provide comfort to lenders that are currently reluctant to initiate new loans.

(2) The Commission should permit the borrowing of a security as a form of close-out for a long fail under Rule 204T(a)(1). This would permit faster close-outs of fails to deliver, and infuse greater confidence in the securities lending markets by allowing a long seller to avoid the unnecessary cost, operational difficulties, and uncertainty associated with buy-ins and premature loan termination.

---

18 Ariel Nelson, When Are Markets Most Volatile?, CNBC By the Numbers (Oct. 30, 2008), available at http://www.cnbc.com/id/27456921 (last accessed Nov. 6, 2008).

19 Indeed, FINRA has indicated that it is investigating possible market manipulation. Regulators Examining Market Close Stock Surges, Reuters (Oct. 23, 2008); see also Floyd Norris, Last-Minute Share Rises Cause Trading Suspicions, N.Y. Times (Oct. 1, 2008) at C6 and Edgar Ortega and Jeff Kearns, Stock Manipulation Probe Launched After Price Spikes, Bloomberg (Oct. 20, 2008).

20 Adopting Release at 61707.

(3) The Commission should implement a de minimis exemption for 204T(a) which exempts a participant's fail to deliver position from the close out requirements of 204T(a) if the net value of the fail in that particular security across all firm accounts is under one million dollars. Such fails should be handled under the regular provisions of Regulation SHO.

(3) The Commission should extend the close-out period under Rule 204T(a)(1) from S+3 to S+6. This change would provide lenders of securities with an adequate grace period to fully reconcile their positions and address any operational or processing delays (on their own systems or those of others) and in which they could attempt to recall loaned securities. It would also permit the borrower to replace the securities through a purchase in the open market, thereby obviating the need for the lender to execute a buy-in.

More generally, as market conditions ease, we urge the Commission to maintain its broad perspective in evaluating Regulation SHO, and to continue its extensive monitoring of short sales and other market data. The evolution of Regulation SHO over the past several years has generally reflected the Commission's balanced and thoughtful approach to the complex issues raised by short sales. We believe that a careful targeting of its provisions, rather than more sweeping market restrictions that risk substantial unintended consequences, offers the greatest protection for improved future market stability. For example, the Commission could consider refocusing the Rule on "threshold securities" and bolstering its protections by reducing the mandatory close-out period for those securities, imposing significantly increased margin requirements for aged fails in such securities, and imposing daily monetary fines for fails in such securities that persist past the close-out period. These measures could be enforced automatically by the National Securities Clearing Corporation, which would ensure compliance in an efficient and low-cost manner. The Commission could also consider expanding the antifraud provisions regarding "naked" short sales to specify penalties for sellers who intentionally fail to deliver in order to avoid the costs of borrowing hard-to-borrow securities.[21]

* * *

[21] See Rule 10b-21 under the Exchange Act.

EWT appreciates the opportunity to comment on Rule 204T and would be pleased to discuss any of the comments or recommendations in this letter with the Commission staff in more detail. If you have any questions, please do not hesitate to contact me at (310) 651-9746.

Sincerely,

Peter Kovac
Chief Operating Officer and
Financial and Operations Principal

cc: Christopher Cox, Chairman
Kathleen L. Casey, Commissioner
Elisse B. Walter, Commissioner
Luis A. Aguilar, Commissioner
Troy A. Paredes, Commissioner
Erik R. Sirri, Director
Robert L.D. Colby, Deputy Director
James A. Brigagliano, Associate Director
Division of Trading and Markets