



STATE STREET.

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

Via email: rule-comments@sec.gov

RE: File Number S7-30-08

**Interim Final Temporary Rule – Regulation SHO Close-out Requirements**

Dear Ms. Harmon:

State Street Corporation (“State Street”) appreciates the opportunity to comment on the interim final temporary rule issued by the Securities and Exchange Commission (“SEC”) relative to the close-out requirements of Regulation SHO, Rule 204T. Headquartered in Boston, Massachusetts, State Street specializes in providing institutional investors with investment servicing, investment management and investment research and trading. With \$14 trillion in assets under custody and \$1.7 trillion in assets under management as of September 30, 2008, State Street operates in 26 countries and more than 100 markets worldwide.

State Street fully supports the SEC’s policy objective of eliminating abusive “naked” short selling. We also support the more general objective of minimizing, where possible, persistent fails to deliver. We recognize, however, that short selling remains a legitimate and important tool in the promotion of a liquid, efficient and transparent financial market. We also note that there are important operational implications to changes in Regulation SHO, which if not properly calibrated, can undermine the orderly functioning of our securities markets. These include increases in transaction volumes and costs, a decline in overall post-trade efficiency and an escalation in industry loss exposure.

State Street therefore welcomes the SEC’s interim final temporary rule, but recommends that it be modified via the changes described below.

## Exclusion of Long Sale Transactions

As intimated in the SEC's proposed rulemaking, long sale transactions do not present the same policy concerns as abusive "naked" short selling and therefore do not readily fit into the temporary Rule 204T framework. This reflects the fundamentally different nature of a long sale transaction, including its more stable and predictable investment horizon. This also reflects the broadly dissimilar nature of its predominant investor base, including mutual funds and other collective investment funds, corporate and public retirement plans, insurance companies, foundations and endowments, all of which play a vital role in the accumulation and management of both savings and retirement assets.

In our view, this is best addressed by fully excluding long sale transactions from the scope of the interim final temporary rule. This is especially true given the strict anti-fraud provisions of Rule 10b-21 which provide the SEC with an effective, broad-based tool to address instances of deliberate market abuse as required. If the SEC proves unwilling to introduce an explicit long-only carve out, State Street recommends that it at least apply the end of day close-out window and the uniform application of the "borrow or purchase" option as described in the further two sections.

## Introduction of an End of Day Close-out Window

As noted by the SEC, there are legitimate reasons why securities transactions may fail to settle on contractual settlement date. This includes human or systems error, especially in instances where transactions involve one or more intermediaries. This also reflects the operational construct of certain well-established investment products. It is instructive to consider in this regard the framework of the US securities lending market, a \$4 trillion pool of equity assets which acts as an invaluable source of market liquidity and hence improved operational efficiency<sup>1</sup>. Consistent with the market as a whole, securities lending operates on the basis of the T+3 settlement cycle. This means that shares which have been sold while out on loan are normally recalled on or prior to T+2, with a three day contractual return window. As is the case for all securities transactions, securities lending recalls can settle at any point throughout the applicable business day, or otherwise fail or default. What these and similar operational considerations demonstrate is the considerable complexity of the existing post-trade system.

Although settlement fails remain the exception rather than the norm, the broker-dealer community has developed via the self-regulatory organization ("SRO") framework, a series of rules to address and help resolve legitimate transaction delays in a timely and cost-efficient manner. These rules have become widely accepted throughout the industry as market best practice, and include (i) the provision of a buy-in pre-notification, (ii) the availability of a window on close-out date in which a failing transaction can settle and (iii) in the event that a forced close out occurs, the provision on execution date of a buy-in notice.

As currently drafted, the SEC interim final temporary rule severely limits the industry's ability to make efficient use of these and other similar failed transaction mitigants. We note in this regard that certain broker-dealers have taken the position that the SEC's temporary emergency close-out rule supersedes all existing market practice. This has resulted in an unfortunate, and in our view, avoidable increase in transactional, operational and market costs. This includes heightened price inefficiency in equity values, due to price spikes at the open of the trading day in response to participants' buy-in activity. This also includes increased operational risk, such as the execution of a buy-in and settlement of the same security transaction on close-out date.

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<sup>1</sup> Risk Management Association – Securities Lending Industry Composite – Lendable US Equity Assets as of June 30, 2008.

State Street therefore recommends that the SEC amend its proposed interim final temporary rule to incorporate an end of day close-out window for both long and short sale transactions. In practical terms, this would mean that a failing transaction would be subject to the rule's existing close-out requirement, but that participants would be given the flexibility to execute the close-out throughout the trading day. In our view, this would provide the industry with the ability to address certain preventable market inefficiencies, without undermining, however, the SEC's overall policy objective. This approach also has the advantage of better aligning the SEC's interim final temporary rule with the market's existing operational framework.

#### Uniform Application of the "Borrow or Purchase" Option

According to the terms of the interim final temporary rule, participants may fulfill their close-out requirements for short sale transactions by either borrowing or purchasing the applicable security. This option is unfortunately not available in the case of long sale transactions. As a result, long investors are automatically exposed to potentially punitive market risk, even in instances of normal course fails. This has proven particularly problematic in light of heightened market volatility and the substantial narrowing of applicable close-out requirements. Moreover, long investors have also been negatively impacted by the decision of certain broker-dealers to forego the practice of providing a written notice of buy-in on execution date with relevant transaction details. In order to mitigate unwarranted market risk, State Street strongly recommends that the interim final temporary rule be amended to allow the close-out of failing long sale transactions by either borrowing or purchasing the required security. This approach has the added advantage of better aligning the operational requirements applicable to both long and short sale transactions.

#### Modification of the Short Sale Close-out Requirement

As with the securities market as a whole, short sale transactions are subject to the operational complexity of the existing post-trade framework. A useful measure of this complexity is the fact that even a covered short sale transaction may have difficulty settling on T+3 since it presumes the timely settlement of the underlying buy (or borrow) cover transaction, also on T+3. Under the terms of the interim final temporary rule, participants are obligated to close-out a failing short sale transaction at the beginning of the trading day on T+4. Since the Depository Trust and Clearing Corporation generally notifies participants of their net delivery obligations at the end of the settlement day (between 3:30 p.m. and 3:45 p.m.), this effectively gives broker-dealers no opportunity to address even normal course short sale fails. In order to prevent the imposition of applicable penalties, broker-dealers have responded by either over-borrowing or over-purchasing relevant securities. This has in turn resulted in an unwarranted increase in both transaction costs and potential market exposure.

Although supportive of the SEC's intent, we believe that its overarching policy objective is unlikely to be negatively impacted if additional flexibility were provided to the industry relative to the close-out requirements of short sale transactions. State Street therefore recommends that the SEC amend temporary Rule 204T so that the close-out requirement for short sale transactions corresponds with the standard currently in place for long sale transactions (i.e. T+6).

#### Other Matters

In response to some of the specific questions posed by the SEC at the end of its comment request, we briefly note as follows:

-The US fixed income market has operational and liquidity characteristics which are dissimilar to those of the equity market. State Street therefore does not recommend an extension of temporary Rule 204T to the debt market.

-The SEC's temporary emergency close-out rule has had a pronounced impact upon the cost of borrowing. We also note the additional transactional, operational and market costs which the industry has had to incur, including entities such as banks and their clients, not directly involved in the practice of abusive "naked" short selling.

Thank you once again for the opportunity to comment on this important matter. To summarize, State Street fully supports the SEC's policy objective of eliminating abusive "naked" short selling and minimizing persistent fails to deliver, but believes that certain changes to the interim final temporary rule should be introduced in order to mitigate certain costly operational challenges. As an initial observation, we recommend that long sale transactions be fully exempt from the scope of temporary Rule 204T. In the alternative, we recommend the implementation of an end of day close-out window for both long and short transactions and the uniform application of the "borrow or purchase" option. In addition, we recommend the introduction of a lengthier T+6 close-out requirement for short sale transactions. Finally, State Street does not recommend the extension of the interim final temporary rule to debt securities and emphasizes the considerable costs of the SEC's approach, as currently drafted.

Please do not hesitate to contact me should you have any questions in regards to State Street's submission.

Sincerely,

A handwritten signature in black ink, appearing to read 'Stefan M. Gavell', written in a cursive style.

Stefan M. Gavell