1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

December 16, 2008

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

Re: Amendments to Regulation SHO (File No. S7-30-08)

Dear Ms. Harmon:

The Investment Company Institute[1] supports the Commission's continuing initiatives to address market manipulation and practices related to abusive short selling.[2] The Commission's efforts to promote fair and orderly markets and address sudden and excessive fluctuation of securities prices are critical to our members. The Commission's interim final temporary rule – Rule 204T – is intended to further these efforts by inhibiting abusive "naked" short selling through the requirement that securities be purchased or borrowed to close out any fail to deliver position.

While ensuring that the public securities markets are adequately protected against abusive trading practices, it is essential that the Commission develop proposals in a manner that maintains the liquidity and price discovery benefits of short selling in the markets. We are concerned that, contrary to the Commission's stated intention, certain aspects of Rule 204T associated with the timing and close-out process may have an unintended impact on the securities lending market and therefore the efficient functioning of the markets. Accordingly, we urge the Commission to consider whether there are any necessary and appropriate modifications that should be made to Rule 204T to address this concern.

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $10.10 trillion and serve almost 90 million shareholders.

[2] *See Amendments to Regulation SHO*, SEC Release No. 58773 (October 14, 2008), 73 FR 61706 (October 17, 2008) ("Release").

Rule 204T

Interim final temporary Rule 204T provides that sellers of equity securities and their broker-dealers deliver securities by the close of business on settlement date – *i.e.,* T+3. Fail to deliver positions must be closed out no later than the beginning of regular trading hours on the settlement day following the day the fail to deliver position occurs. Broker-dealers in violation of this "close-out" requirement are prohibited from further short sales in the same security unless the shares are located and pre-borrowed. Rule 204T provides a limited exception from the close-out requirement for fail to deliver positions resulting from long sales of equity securities. Specifically, a broker-dealer that can demonstrate on its books and records that a fail to deliver position resulted from a long sale will have until the beginning of regular trading hours on the third consecutive settlement day following the settlement date to close out the fail to deliver position by purchasing securities of like kind and quantity – *i.e.,* T+6.

In conjunction with this exception for long sales, the Commission provides guidance in the Release on the treatment of a long sale of a security that is on loan. The Commission states that a sale that is otherwise a long sale would not be treated as a short sale for purposes of Rule 204T if the security has been loaned out and a bona fide recall is initiated within two business days after trade date.[3] Under this circumstance, the sale of a security out on loan would be treated as a long sale and the broker-dealer would have until the beginning of T+6 to close out a fail to deliver position resulting from the sale.

Securities Lending Market

Despite the provision under Rule 204T of a longer period to close out the fail to deliver position for a long sale of equity securities, the timing and close-out requirements of the temporary rule have the potential to create disincentives for holders of long positions to lend their securities. Among other reasons, investment managers may be disinclined to loan securities if there is a risk that the manager will be exposed to frequent buy-ins, the portfolio manager will be unable to sell the loaned security when it chooses without the sale being treated as a short sale (because of an untimely recall notice), or the counterparty risk for timely return of a lent security is high.

These consequences arise in the following manner under the Rule. A buy-in takes place when a broker-dealer closes out a customer's fail to deliver position, requiring repayment at whatever price the broker executed. If an investment manager has a security out on loan, and a fail to deliver position results from the long sale, it is not infrequent that a buy-in occurs before the borrower is able to return the security on a timely basis. In this situation, the manager is exposed to the price difference between the sale price of the security and the buy-in price. We have heard of instances in which broker-dealers are not waiting until the close-out date for long sales as provided in Rule 204T but are executing a buy-

[3] This interpretation incorporates guidance previously provided by the Commission with respect to its September 2008 short sale emergency orders. *See Guidance Regarding Sale of Loaned But Recalled Securities*, Division of Trading and Markets (dated September 28, 2008).

in as soon as practicable in order to obtain pre-fail credit or avoid being forced to buy on the open of trading on T+6. The fail to deliver positions resulting in buy-ins may arise from a number of factors including miscommunications or errors at the custodian,[4] operational issues at the broker-dealer,[5] or borrower defaults. Nonetheless, the end result for the investment manager is the same – a buy-in – and the manager will be less likely to maintain its security lending program if exposed to this constant risk of uncertainty and economic penalty.

In addition, pressures on the securities lending market arise from the concern that a security will not be returned by the borrowing counterparty sufficiently promptly to avoid regulatory penalties to the lender under Rule 204T. This situation exists even with the Commission's guidance that sales of securities out on loan will be treated as long sales. Completion of the recall process for lent securities often concludes by the close of trading on T+6. Yet, the interim final rule provides that market participants must close out a fail to deliver position resulting from a long sale no later than market *open* on T+6. Consequently, lenders are at risk of non-compliance with Rule 204T due to operational events beyond their control. Again, this risk will likely diminish the investment manager's enthusiasm to engage in securities lending.

Recommendations to Address Concerns Raised by Rule 204T

In light of the concerns described above, we encourage the Commission to review fully the implications of Rule 204T and to address any unintended consequences for, or impediments to, the effective operation of the securities lending markets. To that end, we recommend that the Commission expeditiously undertake a review of the impact of the rule's provisions on securities lending activities and identify ways to modify the rule to reduce untoward effects and costs.

As a starting point, we recommend two modifications to Rule 204T that should assist in reducing some of the potentially negative implications on securities lending activity stemming from the rule. First, we recommend that the Commission clarify the difference between a close out on the open on T+6 and a buy-in earlier to obtain pre-fail credit. Clarity on this point should provide a better understanding for market participants regarding their obligations and exposures under Rule 204T.

Second, we recommend that the Commission allow the close out on T+4/T+6 to occur via a weighted price order, such as a volume-weighted average price ("VWAP"), on that day, not just through an opening trade as specified in the interim final rule. Under the limitations of 204T, permitting a close out through a VWAP transaction over the course of T+4/T+6 would be sufficient to prevent the close out trade from placing pressure on a stock at the opening. Further, this modification would

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[4] The current system for issuing buy-in notices varies greatly among broker-dealers with respect to the timing and form of notice provided to investors. This lack of uniformity and automation results in occasional fails to deliver and buy-ins because of miscommunications and/or errors between custodians, broker-dealers and investors.

[5] For example, we understand that in some cases broker-dealers are not able to distinguish between long and short sales, which results in these broker-dealers treating all sales as short sales and therefore buying-in before T+6.

protect institutional investors from being subject to the volatility and uncertainties of the market open during the close out, particularly during these times of market turbulence, and should not present the risks that the interim final rule was designed to address.

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We appreciate the opportunity to comment on interim final Rule 204T. If you have any questions regarding our comments or need additional information, please contact Ari Burstein at (202) 371-5408 or the undersigned at (202) 326-5920.

Sincerely,

/s/ Heather Traeger

Heather Traeger
Assistant Counsel

cc: The Honorable Christopher Cox, Chairman
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes

Erik Sirri, Director
Robert L.D. Colby, Deputy Director
James Brigagliano, Associate Director
Josephine J. Tao, Assistant Director
Division of Trading and Markets

Andrew "Buddy" Donohue, Director
Douglas J. Scheidt, Chief Counsel
Stephen N. Packs, Senior Counsel
Division of Investment Management