SIFMA
Securities Industry and Financial Markets Association

December 16, 2008

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

Re: Release No. 34-58773: File No.S7-30-08;
Amendments to Regulation SHO – Rule 204T

Ms. Harmon:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to provide comments on the above-referenced release, which adopted interim temporary final rule 204T of Regulation SHO ("Rule 204T" or the "Rule").[2] Intended to further address potentially abusive "naked" short selling in all equity securities, Rule 204T bolsters the delivery obligations under Regulation SHO by (i) imposing a "hard delivery obligation" on all long and short sales of equity securities, so that such securities must be delivered by close of business on settlement date; (ii) requiring "immediate" close-out of open fail to deliver positions by borrowing or purchasing securities, as applicable, by no later than the beginning of regular trading hours on the day following settlement date of the fail; and (iii) imposing penalties for failure to timely close-out open fail positions.

I. Introduction and Executive Summary

SIFMA shares the Commission's concern about possible adverse effects on our markets that may result from potentially abusive "naked short selling" practices.[3] In that regard, SIFMA fully supports reasonable and measured Commission action to detect, prevent and punish both the spreading of false rumors and manipulative naked short selling practices.

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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. 58773, 73 FR 61706 (October 17, 2008) ("Release").

[3] The term "abusive naked short selling" generally refers to instances of selling short without having the stock available for delivery and intentionally failing to deliver stock within the standard three-day settlement cycle. Exchange Act Release No. 34-58774 (October 17, 2008) ("Naked Short Sale Anti-Fraud Rule")

SIFMA generally supports the fundamental tenets of Rule 204T, including a compressed mandatory close-out obligation for equity securities and not simply threshold securities as currently required under Regulation SHO. SIFMA believes, however, that the Rule's close-out construct is unduly restrictive and, accordingly, has resulted in certain unintended negative consequences. Specifically, because the Rule mandates that market participants immediately close-out fail positions by the opening of trading on the applicable date designated by the Rule (the "Close-Out Date") -- regardless of the amount or cause of the open fail, or potential market ramifications that might flow from closing out at market open -- the Rule has inadvertently contributed to increased market volatility, dramatic price spikes, instability in the securities lending markets and increased costs to investors.[4]

Therefore, SIFMA strongly urges the Commission to take action expeditiously to address these adverse impacts by amending the Rule as follows:

(i) extend the Close-Out Date for all transactions to S+3 so that participants can take action to close out fails related to both short and long sale activity on or before the third consecutive settlement date; and

(ii) permit participants to responsibly close-out the open fail position throughout the trading session on the Close-Out Date, and not only at the beginning of trading.

Specifically, as described in Part III herein, this modest extension of the close-out time period would afford participants sufficient time to work within existing operational constraints and more accurately evaluate their fail to deliver positions without detracting from the Rule's overall goal of reducing fails. Moreover, since data previously released by the Commission demonstrates that the vast majority of fails settle naturally within a few days following the regular settlement date, SIFMA's proposed amendment would allow for market resolution of normal course settlement delays without requiring otherwise unnecessary transactions that might result in temporary artificial price swells, impeded liquidity, or needless market risk and expense. The S+3 Close-Out Date would also promote regulatory efficiency and ease of compliance by creating symmetry in application between long and short activity, thereby enabling participants to utilize existing operational and compliance systems developed for purposes of Regulation SHO.

Similarly, affording participants greater flexibility to close-out open fail positions throughout the trading session on the close-out date would significantly alleviate the market pressures associated with execution of potentially large purchases at the opening of trading -- a time when markets are particularly susceptible to price fluctuations. This additional relief, therefore, would facilitate the Commission's goals of maintaining fair and orderly markets without creating any material delay to the close-out process under the Rule – trades effected at market open or later during the trading session are treated identically from a clearing and settlement perspective.

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[4] Rule 204T provides that to the extent a participant can attribute the fail to either a long sale or market maker activity, the participant may close-out the position on the third consecutive settlement day following settlement date.

Finally, in Part IV, SIFMA further requests that the Commission provide certain modifications and clarifications to the current language of the Rule. These requests include:

(i) modify the Pre-Fail Credit provision to better promote early close-out of fail positions;
(ii) resolve current inconsistency between Rule 204T and Rule 203 of Regulation SHO; and
(iii) provide a de minimis exemption for a participant's fail positions, per security, that are below a certain level.

SIFMA's detailed comments, recommendations and responses to questions are provided below.

II. Unintended Negative Consequences of Rule 204T Close-out Requirements

SIFMA shares the Commission's concerns about persistent fails to deliver.[5] In that regard, SIFMA generally supports the extension of the Regulation SHO close-out requirements beyond threshold securities, and compressing the current timeframe for close-out. The greatly compressed timeframe provided for currently under Rule 204T, however, is unduly restrictive and does not allow participants sufficient time to fully evaluate and responsibly close-out all their open fail positions. Consequently, although clearly well intended, this provision may have contributed to market volatility and erratic price movements at market open to the ultimate detriment of investors. It also has generated over-buying and borrowing of securities that would otherwise settle in the normal course, thus impairing liquidity by tying up shares that would otherwise be available to natural buyers and sellers. To fully understand the difficulties and practical impacts associated with the Rule, we begin with an overview of the root causes of most fails to deliver.

A. Frequency and Causes of Fails to Deliver

As a general matter, the vast majority of fails to deliver do not involve the type of abusive "naked short selling" activity that the Commission has sought to address through Rule 204T, but rather can stem from the complexity of the settlement process that impacts the flow of securities to the broker-dealer that has a CNS delivery obligation. Consequently, any normal course complication in the process could result in a delay or two in settlement.

Fails can also be triggered by a host of other issues, ranging from counterparty instruction errors to delays attributable to corporate reorganizations or issuance of stock dividends. For example, in counterparty transactions each side needs to match their instructions before the trade will settle – any difference in instructions will result in a delay in settlement until both sides are able to research and resolve the conflicting instructions. Fails can also stem from conversions or transfer agent processing delays, wherein the party owing shares is at times unable to deliver shares, due to

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[5] Notably, SIFMA continues to believe that the Commission's policy objectives behind Rule 204T, as well as the other actions that the Commission has taken (e.g., Rule 10b-21) to address potentially abusive naked short selling can be facilitated by proceeding to adopt the revised Prime Broker Letter. As the Commission is aware, the industry, through the SIFMA Prime Brokerage Committee, has engaged in extensive collaborative efforts with the Staffs of both the SEC's Division of Trading and Markets and FINRA regarding revisions to the Prime Broker Letter. These revisions are intended to enhance communications between the prime broker and executing broker and to help ensure that the customer is providing accurate information to the executing broker.

processing delays either for its own account or the account of the firm that owes it delivery. This may result in a participant and/or an introducing broker being subjected to the Rule 204T Penalty Box restrictions, which prohibits the effecting of short sales, as well as possibly long sales where there is no reasonable expectation of delivery, due to the fact that in many situations a borrow or arrangement to borrow can't be secured prior to sale. At least one firm has also observed instances where DTCC will occasionally freeze deliveries on certain securities, often as a result of a corporate reorganization or insolvency. We understand that these "chills," as they are called, prevent share movements and, therefore, deliveries. In that regard the firm reported that a significant percentage of securities on which they failed and on which buy-ins cannot be executed (*i.e.*, these securities are in the 204T "penalty box") is due to the issue being chilled at DTCC.

Notwithstanding the complexity of the settlements process, firms generally settle the vast majority of their trades on a timely basis. Indeed, the Commission has repeatedly acknowledged as much, citing data from the National Securities Clearing Corporation ("NSCC") that states: "99% (by dollar value) of all trades settle on time. Thus, on an average day, approximately 1% (by dollar value) of all trades . . . fail to settle. The vast majority of these fails are closed-out within five days after T+3."[6]

Rule 204T nevertheless requires participants to immediately close-out all fails to deliver by the beginning of regular trading, including those fails the Commission recognizes as not being abusive, and which will settle naturally in the normal course within a few days. For firms, however, the close-out process is manual in nature and involves intensive monitoring of multiple levels of data across various system platforms and business units within the firm.[7]

B. Issues Related to Close-Out Process Under Current Rule 204T

For participants, the close-out process typically begins with the National Securities Clearing Corporation ("NSCC") notifying participants of their net delivery obligations sometime between 3:30 p.m. and 3:40 p.m. on T+3. Upon receipt of this notice, the clearing participant must then ascertain, where possible, the root cause of the fail on a granular trade-by-trade-level, including which trades relate to long sales versus short sales,[8] determine which clients are at risk of close out and provide notification, as well as afford broker-dealer clients the opportunity to claim Pre-Fail Credits, as applicable. As a practical matter, this process usually cannot be completed by the time the market closes at 4:00 p.m. on T+3, but rather extends forward to the following morning (S+1) to allow participants time to assess borrowing capabilities and to receive Pre-Fail Credit

[6] Securities Exchange Act Release No. 58774, 73 FR 61666, 61667 (October 17, 2008)(adopting the new anti-fraud rule, Rule 10b-21).

[7] One firm has indicated that, at least initially, operations personnel spent an extra 60 man-hours per day to comply with the Rule. While this time allocation has tapered down somewhat through automation, it remains very high.

[8] Participants must, where possible, distinguish between fails caused by long sales versus short sales since Rule 204T applies different close-out requirements to each. In this regard, the CNS report received by clearing firm participants does not differentiate between long and short fails (or, for that matter, sales and purchases), but rather merely shows the participant's net failure to deliver obligation to CNS (if any). As a result, the participant must review the report and determine, on a granular trade-by-trade level, which fail activity relates to short sales, versus long sales.

certifications. Depending on the number of affected securities, and the nature of the securities (*e.g.*, Pink Sheet and OTCBB), the full quantity of shares that are subject to close-out may in some situations not be readily available prior to or immediately at the beginning of regular trading on S+1.

Because the Rule obligates participants to close out the *entire* amount of the fail no later than the beginning of trading, the impacted securities will often experience sudden price spikes at the open, only to be followed by an abrupt decline once all of the close-out purchases are effected. These types of price dislocations are detrimental in that market participants are led to believe that the inflated prices reflect a true market trend. Thinly-traded securities are particularly susceptible to such volatile market movements. Thus, rather than addressing the Commission's overarching concerns about a "substantial threat of sudden and excessive fluctuations of securities prices generally and disruption in the functioning of the securities markets that could threaten fair and orderly markets,"[9] the Rule's compressed close-out requirement has actually served to exacerbate these adverse market conditions.

While recent market conditions make it difficult to attribute causes to one single factor, SIFMA firms believe that the Rule has contributed to the following:

1. Increased Volatility

Estimates from a member firm are that price volatility has increased 57% (based on median close to close) or 46% (based on median intraday). In addition, the VIX (a widely-followed measure of market volatility) has experienced an extremely steep rate of increase. Estimates are that options spreads have widened by approximately 79%, and equity spreads widened from approximately 27% to 32%, depending on the characteristics of the security. The average increase in spread was 28%.[10]

Several SIFMA firms have witnessed a significant amount of upward pressure in those securities being bought-in en masse by several clearing participants at essentially the same time.[11] A review of trading in hard-to-borrow option stocks (*i.e.*, securities with overlying listed options) over the month of November 2008 suggests that stock openings in such securities routinely experienced significant volatility price swings as the result of mandatory buy-ins under Rule 204T. For example, there were at least 40 instances where a hard-to-borrow option stock opened up over

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[9] Release, 73 FR at 61707.

[10] In compiling these estimated market impacts, the SIFMA member firm analyzed securities in the Russell 3000 index (with the exception of securities subject to the September 18, 2008 Emergency Order prohibiting short selling in certain financial stocks) and then compared publicly available data relating to securities markets trading in the remaining securities for the two weeks prior to the 204T Emergency Order to the first two weeks of that order.

[11] For example, trades were reported on September 29, 2008 in the following at times securities that suggest buy-in activity:

Ticker	Price Spike	Average Price	% Increase
WFMI	$22	$19.52	+12.7
JOSB	$36.38	$32.75	+11
SHLD	$100.29	$92.01	+9

15% from the previous night's close, only to quickly recede (within thirty minutes) to around the previous night's closing value. In at least a dozen of those instances, the "spike and crash" scenario of such mandatory buy-ins involved 30 minute price moves of over 25% from the previous night's close. These would appear to be obvious instances where the rule is causing undue volatility of a destabilizing nature.

Such "false buy pressure" resulting from Rule 204T compliance can have many deleterious impacts on the market and investors, including sending out misleading pricing information about a security to the market. For example, a customer may decide to purchase a security at the inflated price, based on a mistaken belief that it is rising for fundamental reasons, only to have the price subsequently collapse. Price spikes may also generate uncertainty and rumors as market participants attempt to determine what factors may have contributed to the unusual activity. SIFMA firmly believes (and we would hope the Commission agrees) that, as a general matter, Commission rules should not have the effect of fundamentally impacting market prices, or obscuring transparency.

2. Premature Borrows and Over-Buying

Another consequence of the Rule is that participants will over-borrow or over-purchase securities at market open on the Close-Out Date even if they know or have reason to believe that the securities will likely settle in the normal course within a few hours that day or within the next settlement day or two. Such action may significantly increase costs and market risks to participants and investors, without materially reducing the number of fails. For example, the participant may borrow securities even in situations where those borrowed securities ultimately are not necessary to meet the firm's settlement date delivery obligations. As a result, the firm incurs increased borrowing costs that may be passed along to customers. Additionally, to the extent that significant amounts of inventory are removed from the securities lending market, liquidity in such securities may be reduced.[12]

3. Instability in the Securities Lending Market

The continued operation of a liquid and efficient securities lending market is fundamental to minimizing fails to deliver, the stated policy goals of Rule 204T and Regulation SHO. Paradoxically, the current structure of 204T threatens both the liquidity and stability of this market, as described below. Although the Commission has clearly indicated that the purpose of the Rule was to address potentially abusive naked short selling, SIFMA firms have often experienced that fails to deliver mandating action under Rule 204T are caused by sales of securities that a person owns but that have been loaned out. For example, SIFMA firms may have large institutional customers whose securities have been loaned out through the services of their custodian or agent lender. Upon the institutional customer selling the long position, the custodian or agent lender will attempt to recall the securities loaned; however, there may be temporary delays in the securities being returned.

[12] Over borrowing may also raise issues with respect to Reg. T Section 210.10 (a) which allows a broker-dealer to borrow for the purpose of making delivery of securities in the case of short sale, failure to receive securities required to be delivered. The rule allows the broker-dealer to make such borrowing only up to one standard settlement cycle in advance of trade date.

The sale of securities on loan is considered a long sale, a fact reaffirmed by the SEC in a FAQ with respect to the series of emergency orders issued earlier this year.[13] Thus, the close-out requirement for long sales under Rule 204T could apply to sales of such securities.[14] However, as discussed in Section II.B. above, due to the difficulty that broker-dealers have in delineating their net CNS delivery requirements into the portion that are attributable to long sales, as opposed to short sales, the lenders of shares are often being faced with a buy-in as if the sale was executed as a short sale.

Consequently, SIFMA members have experienced situations in which they were required to purchase securities, oftentimes in large quantities, by the opening of regular trading hours on S+1, even though 204T provides for two additional days to make delivery for long sales. This has been the case even in situations when the customer's custodian or agent lender has indicated that the securities would be delivered that day. This accelerated buy-in risk acts as a disincentive to lending and causes institutions to question their participation in lending programs at a point when lending has been particularly important to the market. Since these large institutional customers are a major source of availability in the securities lending market, removing these sources will have a negative impact on the ability to borrow securities which could reduce market liquidity.

The pressure on the securities lending market would be reduced by adopting a uniform S+3 Close Out Date for delivery failures. This would eliminate what is now the early close out of sales of securities on loan as if these are short sales and would permit the recall process to function to get securities back into the accounts of lenders in time to make delivery prior to being closed out.

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[13] The SEC FAQ states:

> **Question:** Some market participants have read the Emergency Orders to say that if a person that has loaned a security to another person sells that security, and a bona fide recall is initiated within two business days, then the sale should be treated as "long" for purposes of the Commission's Emergency Orders. Is this a correct interpretation of the Emergency Orders?
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> **Answer:** Yes, we agree with this interpretation of the Emergency Orders. We confirm that, if a person that has loaned a security to another person sells the security and a bona fide recall is initiated within two business days after the trade date, the person that has loaned the security is deemed to own the security for purposes of Rule 200(g)(1) and Rule 200(b) of Regulation SHO, and such sale will not be treated as a short sale for purposes of:
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> i. Form SH in the Order Requiring Institutional Money managers to Report New Short Sales, Exchange Act Release 58591 (September 18, 2008), as amended, Exchange Act Release 58591a (September 21, 2008);
> ii. The Order Halting Short Selling in Financial Stocks, Exchange Act Release No. 58592 (September 18, 2008), as amended, Exchange Act Release 58611 (September 21, 2008); and
> iii. Rule 204T in the Order to Protect Investors against "Naked" Short Selling Abuses, Exchange Act Release 58572 (September 17, 2008).
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> For purposes of the above-referenced Emergency Orders, we confirm that a broker-dealer may mark such orders "long." In addition, a broker-dealer may mark such orders as "long" sales provided such marking is also in compliance with Rule 200(c) of Regulation SHO.
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> http://www.sec.gov/divisions/marketreg/loanedsecuritiesfaq.htm

[14] The longer delivery period permitted for long sales is critical for entities that lend securities given the recall process that applies to securities on loan. Both as matters of contract under the Master Securities Lending Agreement and market practice, a borrower typically has the standard settlement period that applies to a loaned security to return the securities once they have been recalled. This period is appropriate because the borrower may actually need to purchase the securities in order to return them should other borrowable shares not be available.

4. Penalties Upon Participants Due to Actions/Inactions by Others

Some member firms have experienced situations where they have been forced to place themselves and other customers and introducing firms in the "penalty box" because of a failure by an issuer to have new shares available to the market. This has required the participant to work with the transfer agent and DTCC to have physical certificates processed so that the securities can be made available. Member firms note that there are no restrictions/penalties imposed upon such other parties, however the penalty box provisions can be severe to both the firm and its customers.

III. SIFMA's Recommended Alternative

In light of the forgoing, SIFMA urges the Commission to amend Rule 204T so that the close-out requirement applies only to those fail positions (for both long and short sales) in an equity security at a registered clearing agency that remain open for two consecutive settlement days following the settlement date. Thus, participants could take action to close-out open fail positions no later than the close of trading on the third settlement day (S+3). These modifications, we believe, would significantly alleviate the market volatility and operational difficulties associated with the current close-out requirement, without significantly detracting from the SEC's stated goals in enacting Rule 204T. The proposed amended Rule 204T would read as follows:

> *If a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security for two consecutive settlement days following the settlement date, the participant shall thereafter close-out the fail to deliver position by borrowing or purchasing securities of like kind and quantity, by no later than the close of regular trading hours on the next settlement day.*[15]

To the extent that a participant is unable to borrow or purchase securities to close-out an open fail to deliver position, then the participant would be subject to many of the same self-executing "Penalty Box" provisions as current Rule 204T(b). Specifically, the participant and any broker-dealer from which it receives trades for clearance and settlement, would be restricted from accepting short sales in that security from another person, or effecting short sales for its own account, without first borrowing or arranging to borrow the security, until the participant closed out the fail by purchasing securities (and such purchase settles) or by the participant borrowing and/or otherwise receiving securities and delivering such securities to NSCC to eliminate the participant's fail position. While this latter point may be reasonably interpreted under the current Rule (*i.e.*, that a participant ceases to be subject to the Penalty Box provisions when its fail to deliver position at a registered clearing agency is eliminated) SIFMA requests that the Commission confirm this guidance, as the literal reading of the current Rule is that the Penalty Box restrictions are lifted by "purchasing." This being the case, it would be illogical to still require a participant to purchase securities to cure the Penalty Box restrictions in situations where the participant no longer has a fail

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[15] For example, if a participant has a CNS fail position of 1000 shares on the regular settlement day of Tuesday (S), to the extent the fail position remains open on Wednesday and Thursday, the participant would have to take action to close out the fail position by close of trading on Friday (S+3).

position, due to securities being borrowed or the participant receiving securities from the seller (*e.g.*, in connection with long sales).[16]

This recommended approach would advance the same policy objectives of significantly reducing the number of prolonged fails in all equity securities, while also avoiding many of the adverse market impacts described above. At the same time, SIFMA's approach would promote greater market efficiencies and more streamlined, effective regulation.

A. Ability to Effect Close-Out Transactions Throughout Trading Session Reduces Market Volatility Without Creating Material Delays

Granting participants more latitude to close-out fail positions in an orderly fashion beyond market open would significantly alleviate many of the negative unintended consequences flowing from the current Rule, including market volatility caused by execution of potentially large purchases at the open. As a practical matter, transactions effected at market open to close-out open fail positions are no different from those effected later on in the trading session because both are part of the same clearance and settlement cycle. Thus, providing this relief would not add any delay of consequence to the close out process.

B. Recognition of Normal Course Deliveries

As noted by the Commission and as noted above, fails to deliver occur for a host of reasons, many of which are completely unrelated to naked short selling, including fails due to operational or processing delays or due to bona-fide market making activities.[17] Because, as the Commission has confirmed, settlement delays typically clear up in the normal course within a couple of days, SIFMA's recommended alternative of requiring close-out for those fails that persist for two consecutive settlement days would avoid needless borrowing and purchasing of securities, thus reducing the need to take unnecessary market action and allowing firms to calibrate more accurately the amount of securities necessary to close-out the fail. Due to the fact that most deliveries are made by the third day after settlement, the amount left to be closed-out under the proposed amended Rule

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[16] In addition, SIFMA notes that pursuant to Rule 204T(d), a clearing firm is able to allocate close-out responsibility to a broker-dealer customer, whereby <u>sole</u> responsibility for closing out the fail and for the consequences of failing to do so rests with the broker-dealer customer and not with the clearing firm. This being the case, Rule 204T(d) also currently contains a requirement that the broker-dealer who is allocated a fail to deliver position notify the clearing firm when it is in the "Penalty Box", with the Release explaining the rationale for this being so that the clearing firm "will be on notice that the broker-dealer is subject to the borrow requirements...." (Release 73 FR 61714, p. 65.) SIFMA believes that this requirement is unnecessary and otherwise inconsistent with the allocation approach, and furthermore raises questions as to what the Commission expects clearing firms to do with this information. Any clarity from the Commission on this point would be helpful so that clearing firms can put processes in place to comply.

[17] The operational and practical reasons for fails to deliver and the need for a limited period of time after settlement to resolve fails resulting from ordinary course delays has been acknowledged in prior regulations. For example, the Commission took into account these ordinary course delays in formulating the T+13 close-out requirement of Rule 203(b)(3) in Regulation SHO, and this extended close-out period applied only to a small group of fails of threshold securities which exhibited extensive fails, rather than all fails of equity securities as does Rule 204T(a). See Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008, 48017 n. 93 (August 6, 2004). The T+13 close-out requirement of Rule 203(b)(3) of Regulation SHO was determined in part because it was consistent with the timeframe of former NASD Rule 11830 and the requirement of Rule 15c3-3(m).

would be relatively small, thus minimizing to a large extent the negative impacts of buy-ins, as set forth above.

Moreover, SIFMA's alternative would apply a uniform close-out requirement to all fails to deliver, without regard to whether the fail was caused by a short sale (including a short sale effected by a market maker in connection with its bona-fide market making activity) or a long sale. The proposed amended Rule would facilitate compliance, as participants would no longer need to engage in often complex processes to attempt to determine the root cause of their CNS fails to deliver, so as to apply and track bifurcated close-out timeframes.[18]

C. Consistency with Other Buy-in Rules

Fails may often be attributable to one firm not receiving the shares in a timely manner from another party. Established industry practice is for the firm performing the buy-in to pass the associated costs to the party that is failing to deliver shares (*i.e.*, to the party it determines to be responsible for the fail). Existing self-regulatory organization rules governing this practice are generally designed to provide sufficient notice to the failing party so that such party may actually make delivery, thereby avoiding potentially market disrupting buy-ins. Rule 204T's current timeframes are too compressed in many situations to permit such notices to be provided. Accordingly firms have had difficulty passing liability to the responsible party, and unnecessary buy-ins have resulted. SIFMA's recommended proposal would permit sufficient time to provide notices to failing counterparties under normal circumstances, thus maximizing the opportunity for actual delivery and ensuring that the parties responsible for fails ultimately bear the costs.

D. Aid the Stability of the Securities Lending Market

Permitting several additional days to deliver stock upon sale will permit lenders to issue recalls with sufficient time to obtain securities and make delivery, or to pass buy-in costs under the relevant contracts should the recalled securities not be returned as required. This should help alleviate the issues experienced with the current Rule, as outlined above, including reducing buy-in risk to lenders and, therefore, improving the stability of the lending market.[19]

E. Ease of Implementation and Compliance

Because SIFMA's recommended alternative is based on the existing Regulation SHO framework of aging and eliminating fails to deliver, the systems necessary to manage this process should already exist and should require smaller amounts of modification, thus reducing implementation costs. The SIFMA proposal is also simplified in its approach, thus minimizing costs associated with having to build, maintain and track separate fail management processes, as well as the likelihood of errors in doing so. Additionally, policies, procedures and surveillances which

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[18] SIFMA would still urge the SEC to retain the exception for fails to deliver resulting from Rule 144 sales, and extend the exception to cover other sales of securities that a person owns, but is unable to deliver on settlement date (for example, stock subject to a prospectus delivery obligation).

[19] SIFMA believes that such action would be consistent with other action the Commission has taken to alleviate the impacts of the recent changes in short sale regulations on securities lending activity, such as the aforementioned guidance provided by the Division of Trading and Markets. *See* http://www.sec.gov/divisions/marketreg/loanedsecurities/faq.htm.

should already exist in some form for purposes of general Regulation SHO compliance could be easily amended to accommodate the new rule, thus reducing the costs of ensuring compliance with the Rule requirements. Extending the Close-Out Date from the morning of S+1 to any time during regular market hours on S+3 for all transactions would also allow participants sufficient time to evaluate their net fail positions and assist in determining the causes of net fail positions. [20]

IV. Necessary Adjustments to Current Rule

In addition to amending the Rule as set forth in SIFMA's recommended alternative, SIFMA urges that the Commission make certain other adjustments to the current Rule in order to avoid some of the negative market impacts described above. Chief among these is the ability for firms to close out the open fail positions throughout the trading day on the Close-Out Date, whatever that day is deemed to be by the Commission. To date, the Commission has not articulated a compelling policy reason for drawing a distinction between trades executed at the open of trading versus any other point during the regular trading session, as they are all compared the following morning. This modification, we believe, would significantly alleviate much of the market pressure and adverse impacts described in Section II.B. above, as well as operational difficulties firms are encountering with having to take action immediately at market open.

A. Pre-Fail Credit Provision

SIFMA also requests certain modifications with respect to the Pre-Fail Credit provision of the Rule which allows a broker-dealer to claim credit for purchases occurring before settlement date that comply with certain conditions, and thus satisfy the participant's close-out requirement.[21]

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[20] The Commission inquired in the Release as to whether temporary Rule 204T should be expanded to apply to debt as well as equity securities. SIFMA notes that the Commission has expressly carved-out debt securities from all short sale regulations, including Regulation SHO, citing in support thereof the non-manipulative potential associated with fixed income securities. Similarly, the Commission has excluded debt securities from the requirements of Rule 105 of Regulation M, citing in support thereof statements from commenters that "debt securities are less susceptible to manipulation...because debt securities trade more on the basis of factors such as yield and credit rating and are priced on factors such as interest rates..." Securities Exchange Act Release No. 56206, 72 FR 45094, 45100 (August 10, 2007). SIFMA believes that this same rationale warrants only applying 204T to "equity" securities, as such term is defined in Section 3(a)(11) of the Exchange Act and Rule 3a11-1 thereunder, and excluding debt securities. Such exclusion should extend to certain structured products that do not fall under the Exchange Act definition of equity. This would include, for example, trust preferred securities, which generally consist of a company establishing a limited business trust, which issues preferred securities to the public and uses the proceeds to purchase junior subordinated debentures from that company. Although many trust preferred securities are traded on exchanges, such securities are merely interests in trusts that own only debt securities, and thus retain the debt characterization of the underlying assets. SIFMA acknowledges that, as the Commission has previously noted, the "equity" status of some structured products may not be clear, and that it therefore may not be feasible for the Commission to make broad-based determinations on whether categories of securities constitute debt or equity. *See Division of Market Regulation: Responses to Frequently Asked Questions Concerning Regulation SHO*, Q&A 1.4. In such situations, participants could be prepared to demonstrate to examiners their justification for treating individual categories of securities as debt securities that fall outside Rule 204T.

[21] Rule 204T(e) provides that a broker-dealer may claim a pre-fail credit if: (1) The purchase is bona-fide; (2) The purchase is executed on, or after, trade date but by no later than the end of regular trading hours on settlement date for the transaction; (3) The purchase is of a quantity of securities sufficient to cover the entire amount of the open

While SIFMA supports allowing Pre-Fail Credit to "clean" fails prior to settlement date, we believe several current interpretations of this provision are impractical and counterproductive to a policy goal of fostering early close-out of fails to deliver.

1. Fail Position vs. Short Position

The Rule's reference to "open short position" rather than "open fail position" is problematic as it seemingly suggests that a broker-dealer could be required to execute a purchase of securities sufficient to close-out the entire *short* position which could exceed significantly the amount of the broker-dealer's open CNS *fail* position.[22]

Clearly, the intent of providing pre-fail credit is to encourage early close-out of open fail to deliver positions and require the broker-dealer to demonstrate that it was a "net buyer" up to the amount of the fail to deliver position.[23] This interpretation is supported by statements in the Release: "to help ensure that broker-dealers purchase sufficient shares to close-out their fail to deliver positions, temporary Rule 204T(e) requires that the broker-dealer claiming pre-fail credit be net long or net flat on the settlement day on which the broker-dealer is claiming pre-fail credit."[24] As written, however, the Rule's language leads to an incongruous result in instances where the broker-dealer takes affirmative measures to close-out an open CNS fail position but retains an open short position.[25] The net effect is to actually discourage early action that might be taken to close-out an open fail to deliver position.

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short position; and (4) The broker or dealer can demonstrate that it has a net long position or net flat position on its books and records on the settlement day for which the broker or dealer is seeking to demonstrate that it has purchased shares to close-out its open short position.

[22] Consider for example the following situation: Broker-dealer has a CNS fail position in ABC security of 100 shares, but has an overall net short position in ABC security of 1 million shares (*e.g.*, the additional 999,900 shares might represent a settled short position that the broker-dealer established 6 months prior). SIFMA believes that the broker-dealer should be entitled to claim Pre-Fail Credit if the broker-dealer effects a purchase of 100 shares from T through T+3, and otherwise complies with the requirements of the Pre-Fail Credit provision. It should not be necessary for the broker-dealer to effect purchases equal to the total amount of the broker-dealer's 1 million share "short position." To hold differently would be entirely inconsistent with the expressed policy consideration underlying the Pre-Fail Credit (*i.e.*, encouraging early action to close-out fails) and would serve no benefit. Moreover, the practical effect would be that the broker-dealer would be executing purchases in amounts well beyond those necessary to clean-up the broker-dealer's open fail position.

[23] This approach is consistent with the prior Regulation SHO interpretation allowing a participant to claim credit for purchases executed prior to the 13th consecutive settlement day, which had included in its conditions the requirements that: "the purchase is of a quantity of securities sufficient to close-out the entire amount of the open fail position that has persisted for 11, 12 or 13 consecutive settlement days, as applicable; and the net purchases of the threshold security effected by the participant on that day, as reflected in such participant's books and records, are at least equal to the amount of such participant's open fail to deliver position in such threshold security on that day." See. Division of Market Regulation, Responses to Frequently Asked Questions Concerning Regulation SHO, Q&A 5.7.

[24] Release, 73 FR at 61715.

[25] Rule 204T(a) mandates that the clearing firm purchase (or borrow, as the case may be) securities of like kind and quantity sufficient to close out the firm's fail to deliver position. This presumes that a clearing firm purchase (or borrow) the amount of its fail to deliver (*e.g.*, if the firm is failing on 10,000 shares, it needs to buy (or borrow) 10,000). This reading is consistent with practice under Reg SHO -- the amount to be closed out is the aged fail amount. However, on page 16 of the Release, the staff states that the clearing firm must be able to demonstrate that

2. Partial Purchase or Borrow

As written, the Rule states that in order to claim Pre-Fail Credit, the participant's purchase be of "a quantity of securities sufficient to cover the entire amount of the open short position." While unclear, the Rule appears to suggest that, to the extent a broker-dealer effects purchases between T and T+3, and such purchases do not add up to the total amount of the participant's open fail position, then the broker-dealer would not be able to claim pre-fail credit for such purchases, even though they could have reduced the open fail position by a substantial amount.[26] SIFMA believes that such a result is unjust, and furthermore discourages a broker-dealer from taking early action to clean-up fails, if the broker-dealer is not going to receive credit for such actions.

Finally, SIFMA notes that Rule 204T speaks to "purchases" being necessary to claim Pre-Fail Credit. Based on the policy objectives underpinning the Pre-Fail Credit provision, SIFMA strongly believes that it should be permissible for a broker-dealer to meet the Pre-Fail Credit provisions by either purchasing or borrowing securities.

3. Customer Close-out

Rule 204T allows a broker-dealer to claim Pre-Fail Credit, but the Commission has not also permitted the provision to extend to purchases by customers. The net effect of this decision is that, even if a customer has otherwise purchased securities on T through T+3 to cover an open short position, a participant might be required to still purchase additional securities by the opening of regular trading on T+4 to meet the close-out requirements of Rule 204T.[27]

SIFMA does not believe there is any policy rationale for limiting the Pre-Fail Credit provision to only purchases effected by broker-dealers, but not customers. While we understand that

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it purchased (or borrowed) the "full quantity" of the fail to deliver, and "therefore, that the participant has a net flat or net long position on its books and records for that equity security on the Close-Out Date." This last phrase seems unconnected to the requirement that a firm buy-in the amount it is failing to deliver. SIFMA requests the Staff's confirmation that it is not envisioned that clearing firm participants purchase or borrow MORE than the amount of the firm's fail to deliver position – such a requirement does not appear in the rule (as contrasted with the pre-fail credit section which explicitly has such a requirement), and is at odds with firms' understanding that the amount to be closed-out is the amount that is failing.

[26] The potential for such a lopsided result is illustrated by the following example: Assume for example that on trade date, Firm A effects a short sale of 100,000 shares of ABC stock. Assume further that on T+2 Firm A attempts to execute a purchase for the entire amount of such short position, but is only able to purchase 99,000 shares due to limited liquidity. Even though the Firm took affirmative measures to reduce the amount of its open fail, because the Firm was unable to purchase the "entire amount sufficient to cover the open short position," under the literal language of the Rule the Firm might not be able to claim a Pre-Fail Credit for the 99,000 shares – an outcome that is entirely inconsistent with the desired effect of that provision.

[27] For example: Assume that a non-broker-dealer customer of a clearing firm participant effects a short sale for 100,000 shares on T, obtaining a locate for the full 100,000 shares from the clearing firm participant. Subsequently, on T+2 the customer purchases 100,000 shares to close-out the entire open short position. Although the 100,000 shares were available to be located on T, on T+3 the shares may be temporarily unavailable, thus leading to the clearing firm participant having a fail to deliver of 100,000 shares. Even though the customer had purchased 100,000 shares, which will settle within two business days, under the Rule the clearing firm participant may not claim Pre-Fail Credit for the amount of such purchase, but rather must execute a purchase for another 100,000 shares by the opening of regular trading on T+4.

the Commission's reluctance to extend the Pre-Fail Credit provision in such manner may be based on a concern of a clearing firm participant "delegating authority" to a customer, over whom the Commission may not have direct jurisdiction, the Rule could clarify that the clearing firm participant retain responsibility for demonstrating, as necessary, that the customer's purchases met all of the requirements of the Pre-Fail Credit provisions of Rule 204T.

B. Inconsistency between Rule 204T and Rule 203 of Regulation SHO

SIFMA also urges the SEC to resolve an unnecessary conflict between Rule 204T(a)(2) and Rule 203(b)(2)(ii) of Regulation SHO. Rule 204T(a)(2) states that a clearing agency participant must close out a fail to deliver position at a registered clearing agency in any equity security sold pursuant to Rule 144 of the Securities Act of 1933 (the "Securities Act") no later than the beginning of regular trading hours on the thirty-sixth consecutive *settlement* day following the settlement date for the transaction by purchasing securities of like kind and quantity (T+39). In addition, footnote 92 in the Release effectively expands the scope of 204T(a)(2) to cover fails resulting from the sales of restricted equity securities where such securities have an effective resale registration statement under Rule 415 of the Securities Act, as well as to sales pursuant to cashless exercises of stock options. On the other hand, Rule 203(b)(2)(ii) provides an exception from the locate requirement for sales of securities that a person is "deemed to own," provided the broker-dealer takes action to close-out the open fail 35 *calendar* days after the trade date.

These rules conflict with each other in two ways. First, there is some overlap between the universe of equities that are covered by Rule 204T(a)(2) and Rule 203(b)(2)(ii). For such securities, there is ambiguity as to which buy-in deadline applies: the one imposed by Rule 204T(a)(2), or the one set by Rule 203(b)(2)(ii). Specifically, 203(b)(2)(ii) requires buy-in of such securities by T+35 (calendar days) – since such deadline occurs prior to the T+39 (settlement days) imposed by Rule 204T(a)(2), this raises a question as to whether a clearing participant must buy-in under Rule 203(b)(2)(ii) before it reaches the Rule 204T(a)(2) deadline. Second, while there is some overlap between the types of equities covered between 204T(a)(2) and 203(b)(2)(ii), the overlap is not exact – as a result, there is a significant amount of confusion regarding whether a sale of a security that a person is "deemed to own" under Rule 200 of Regulation SHO should be subject to Rule 204T or 203(b)(2)(ii).

There is no rational justification for the differences between Rule 204T(a)(2) and Rule 203(b)(2)(ii). It is evident from both Rule 204T(a)(2) and footnote 92 in the proposing release that the SEC agrees that fails resulting from sales of shares that a seller is "deemed to own" – whether because the shares are restricted, are being tendered for conversion, or otherwise – do not implicate the primary focus of Rule 204T(a)(2), which is to address abusive naked short selling. Accordingly, SIFMA urges that the SEC conform Rule 204T(a)(2) and Rule 203(b)(2)(ii). More specifically, SIFMA recommends that the Commission: (i) extend the exception in Rule 204T(a)(2) to cover other situations involving sales of "owned securities," in a manner consistent with Rule 203(b)(2)(ii); and (ii) amend the timeframe for Rule 203(b)(2)(ii) to refer to 35 consecutive settlement days, so as to be consistent with 204T(a)(2).

C. De Minimis Exception.

In response to the question posed by the Commission in the Release, SIFMA believes that the Commission should consider an exception from the 204T close-out requirement for a participant's fail to deliver positions, per security, at a registered clearing agency that are below a specified de minimis threshold. For participants, especially smaller firms with limited execution capabilities, the Rule's close-out requirement has proven to be particularly burdensome in that requires execution of multiple small purchases for many different securities, rather than focusing on purchasing to cover the larger fails in other securities. A voluntary de minimis exception, therefore, would be helpful in that regard. Firms could then decide whether or not to take advantage of the exception based on their particular business model and capabilities, as some firms, particularly larger firms, may in fact find it easier to simply close-out all fails, rather than exclude fails below a de minimis threshold.

V. Conclusion

SIFMA strongly supports the Commission's efforts to address extended fails to deliver, as well as potentially abusive naked short selling. In that regard, SIFMA supports the fundamental tenets of Rule 204T, including a more compressed close-out requirement. As described above, however, we believe the current close-out requirement of Rule 204T creates additional risks and substantial costs for both market participants, and the market as a whole, which are far greater than the benefits sought to be achieved. In light of the negative consequences outlined above, SIFMA respectfully urges the Commission to adopt the proposed alternative version of Rule 204T.

If you have any questions or require additional information, please do not hesitate to contact the undersigned at (212) 313-1268. Thank you for your attention to this request.

Sincerely,

Amal Aly
SIFMA Managing Director and
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