THE RISK MANAGEMENT ASSOCIATION
Serving the Financial Services Industry

1801 MARKET STREET, SUITE 300, PHILADELPHIA, PA 19103- • 215-446-4000 • FAX 215-446-4101 • www.rmahq.org

December 23, 2008

Via email: rule-comments@sec.gov

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

RE: File Number S7-30-08

Interim Final Temporary Rule – Regulation SHO Close-out Requirements

Dear Ms. Harmon:

The Risk Management Association's Committee on Securities Lending 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 Rule 204T of Regulation SHO under the Securities Exchange Act of 1934.[1]

The RMA fully supports the SEC's policy objective in promulgating Rule 204T of eliminating abusive "naked" short selling and of minimizing persistent fails to deliver.[2] RMA also recognizes that the functioning of the securities lending market is critical to minimizing fails to deliver, one of the policy goals of Rule 204T. However, the RMA is concerned that the Rule as written is resulting in several unintended, harmful consequences for beneficial owners that are selling long, and is also undermining the orderly functioning of the securities lending market.

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1 Founded in 1914, The Risk Management Association is a not-for-profit, member-driven professional association whose sole purpose is to advance the use of sound risk principles in the financial services industry. RMA has over 2,700 institutional members that includes banks of all sizes as well as nonbank financial institutions throughout North America, Europe, and Asia/Pacific. RMA's Committee on Securities Lending was formed in 1983. The objective of the Committee is to promote sound securities lending practices within its members and the industry. In the securities lending context, the members of RMA primarily act as "agent lenders", loaning securities on behalf of underlying principal lenders.

2 We recognize, however, that short selling remains a legitimate and important tool in the promotion of a liquid, efficient and transparent financial market.

The RMA's main concerns relate to three issues. First, the date(s) included in the Rule by which market participants must immediately close-out fail positions at the opening of trading (the "Close-Out Date") interferes with the securities lending recall process and creates significant risk for securities lending market participants. Second, market practices regarding pre and post buy-in notifications have been abandoned in light of the close-out requirements, thereby creating further instability and undue risk. Third, the requirement that market participants close out fail positions on the open of T+6 has increased market volatility and created artificial price spikes around the open that harm investors.

To address these concerns, the RMA urges the SEC to adopt the following amendments to Rule 204T:

(1): Extend the Close-Out Date for all transactions to settlement date plus 3-days to ensure that beneficial owners selling on-loan positions are not compromised by close-outs of long sales prior to such date.

(2): Permit participants to close-out open fail positions throughout the trading session on the Close-Out Date (and not only at the open of trading).

(3): Provide for pre and post buy-in notifications similar to those previously followed which were based on FINRA Rule 11810, as well as an amendment to Rule 204T of Regulation SHO to provide for the following:

- **(i) written pre-notice of "buy-in" to be delivered to the seller 24 hours prior to the execution of the proposed "buy-in"; and**

- **(ii) notice of close-out to be delivered immediately but not later than 4:30 pm Eastern Time on date of execution to seller with all pertinent details (account number, asset identifier, number of shares, net amount of original transaction, original trade date, buy-in execution price, buy-in execution net amount and settlement date of the actual buy-in.)**

While RMA supports the Commission's efforts to address persistent fails to deliver and abusive naked short selling, we believe that failure to address these concerns will have far-reaching consequences in the market. If adopted as written, the Rule will cause significant disruption to the investment process of beneficial owners and result in significant losses that cannot be passed on to other parties. Ultimately, this will cause many beneficial owners to withdraw from securities lending, thereby reducing the liquidity and efficiency of the U.S. securities market.[3] We strongly urge the SEC to consider these concerns and our proposals.

II. Background on Securities Lending

a. Securities Lending Arrangements

[3] Such a broad-based termination of securities lending programs would also cause significant disruption in the cash collateral reinvestment market.

Large beneficial owners (*i.e.*, pension funds, endowments, mutual funds, insurance companies and other collective investment vehicles) that participate in securities lending enter into a securities lending authorization ("SLA") with a securities lending agent. The SLA authorizes the lending agent to lend the beneficial owner's securities to certain borrowers pursuant to an agreement that the lending agent, as agent for the beneficial owner, enters into with the borrower. The borrower agreement contains a contractual right allowing the lending agent, on behalf of the beneficial owner, and upon notice to the borrower, to demand the return of the security at any time. The borrowing agreement provides that upon receipt of notice, the borrower has the standard settlement period for U.S. equities (3 days) to return the borrowed security.[4] If the borrower fails to return the security within the contractual period, then under the terms of the borrowing agreement, the borrower is liable for any loss or cost resulting from a buy-in.

b. The Sale of an On-Loan Security

As described below, delivery of sale of an on-loan security often occurs sometime on T+6, as a result of operational requirements and the multiple parties involved. Rule 204T does not currently account for the additional operational complexities that attend the sale of an on-loan position, which has resulted in an accelerated buy-in schedule, which in turn creates a disincentive to lending.

By way of example, consider a fund that is engaged in securities lending. When a security of that fund is on loan, the fund's custodian continues to reflect that position as held long on the fund's books and records. Accordingly, when the fund's investment manager makes the decision to sell a security, that manager does not typically know if any portion of the position being sold is currently on loan.

When the manager places an order to sell a security, the custodian of the fund must be notified of the sale. In most cases the custodian is notified of a sale of a U.S. equity by the end of trade date plus one (T+1). The custodian then enters that information into its custody system in order to affirm and settle that transaction.

If all or a portion of the position being sold is on loan, the custodian must then notify the lending agent. The lending agent may be a division or affiliate of the custodian or it may be an unrelated third-party, such as another custodian or a noncustodial agent lender. Once the custodian has notified the lending agent that a security that is on loan has been sold, the lending agent will first attempt to reallocate that loan to one or more other beneficial owners participating in its lending program that have that security available to lend and have approved the borrower who has borrowed it.

If the loan can be reallocated, then the lending agent makes changes to its books and records to reflect the change in lenders. If the lending agent is a division or affiliate of the lender's custodian, then the custodian upon the notification by the lending agent will make the

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[4] This three day settlement period for the loan return is necessary because, in most cases, the borrower has used the borrowed security to settle a client transaction and therefore must either borrow the security from another party or purchase the security in the market. This purchase transaction must settle before the loan can be returned.

appropriate recordkeeping adjustments to allow the available shares in its omnibus account to be released to settle the sale transaction. However, if the lending agent is a third-party such as another custodian or a noncustodial lender, then a reallocation of the loan requires pre-deliveries between custodians before the sale transaction can be settled. The lending agent must instruct the custodian for the beneficial owner who has been substituted into the loan to deliver the shares to the custodian for the beneficial owner who sold the shares so that the shares can be on-delivered to settle the sale transaction.

If the lending agent cannot reallocate the loan or loans necessary to free up the shares needed to settle the sale transaction, then the lending agent issues a written recall notice to the borrower of the securities. As a result of the time required for: 1) the investment manager to notify the custodian of the sale, 2) the custodian to notify the lending agent and 3) the lending agent to go through the reallocation process, recall notices are typically issued either late in the day on T+1 or on T+2, with the majority of recalls issued on T+2. The borrower who receives the recall notice on T+2 has three full days to return the security, in effect, until the end of the day on T+5.

If the lending agent is a division or affiliate of the custodian, then when the shares are received late in the day on T+5, the custodian must then deliver them to settle the sale transaction. If the lending agent is an unaffiliated third-party, then when the custodian for the lending agent receives the shares late in the day on T+5, it must deliver them to the custodian for the beneficial owner who must then deliver the shares for settlement. In many cases, due to loans returned late in the day on T+5, the ultimate delivery of the shares to the executing broker will not be processed by CNS until the morning of T+6. As discussed below, this operational framework means that sales of on-loan positions processed in the normal course will be subject to a heightened buy-in risk.

III. Rule 204T and the Recall Process

As written, Rule 204T creates two significant disruptions in the securities lending market. First, a mandatory buy-in on the morning of T+6 does not allow for the completion of the securities lending recall cycle, which has led to significant additional costs and risks to beneficial owners participating in securities lending. Second, many brokers are buying in on T+4, which layers on additional risk and inefficiency to the process of selling on-loan positions.

As described above, due to operational complexity and the number of market participants involved in the sale of an on-loan position, it is commonplace for a sale to be settled during the day of T+6. However, under Rule 240T, the executing broker must buy-in at the open of T+6. This lack of coordination between the operational requirements of a securities lending transaction and the requirements of the rule creates heightened risks and costs for beneficial owners.

By way of example, at the open of T+6, the beneficial owners will be bought in, and will be subject to substantial costs and market exposure. The beneficial owner’s shares will have been delivered to CNS and may have been used by the executing broker to settle unrelated transactions. It can take a significant amount of time to get the shares returned by the executing broker, which results in continued market exposure to the beneficial owner and the potential for substantial losses. As described below, this exposure is exacerbated by the fact that the buy-in is required to occur at market open, which causes the security price to spike and results in an inflated buy-in price (followed by market declines and all the while the beneficial owner is awaiting the return of its security from the executing broker).

Second, despite the fact that Rule 204T provides additional time to close out long sale fails, we understand that many brokers are routinely buying in long sales that have not settled on T+4.[5] Therefore, beneficial owners seeking to sell on-loan positions are being bought in routinely, before the recall process attendant to a sale of an on-loan position is complete.

In addition, the lack of uniform pre- and post- buy-in notification, discussed below, means that the recall process, a separate transaction in the marketplace, continues to go forward. If the borrower has had to purchase the security in order to return it, then another market transaction has been created resulting in two entities (the clearing firm and the borrower) purchasing the same security to meet the same settlement obligation. Once the lending agent is notified of the buy-in, in many cases days after the buy-in, these transactions must be unwound and liability assigned. In addition, these increased volumes and securities in transit create significant potential corporate action liability for beneficial owners, custodians, and agent lenders. In sum, when clearing firms buy-in long sales prior to T+6 that are failing because of the standard recall process for on-loan positions, this creates significant confusion in the market, increased operational difficulties and significant liability for beneficial owners, custodians, and agent lenders.

The most troubling aspect of this is that by not allowing the recall process to work, the cost and expenses of the buy-in remain with beneficial owners such as pension funds and mutual funds. This is because the buy-in occurs before the end of the borrower's contractual period for returning the security. As a result, a beneficial owner cannot transfer the liability for the buy-in to the borrower of the security. This liability can be significant due to the spike in the price of the security resulting from the artificial demand created by two entities purchasing the security as well as the market open requirement forcing all clearing firms to close out positions simultaneously. This results in an inflated buy-in price, and the beneficial owner becomes subject to market risk until it receives securities back from the borrower that it can sell to cover this liability. In most cases the price of the security has fallen and the beneficial owner is left with a substantial loss. The resulting reaction of the beneficial owner is to withdraw from the lending market.

In light of these concerns, we strongly urge that the rule be amended as follows:

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[5] We have heard the following explanations for this practice: 1) certain clearing firms do not have the operational capability to identify long sales within their CNS net position and, therefore, cannot allocate their settlement obligation between and among long and short sales; and 2) broker-dealers have determined that closing out on T+4 is preferable to exposure to prohibitive penalties imposed by Rule 204T for failure to timely close out positions.

(1) extend the Close-Out Date for all transactions to S+3 to ensure that beneficial owners selling on-loan positions are not compromised by close-outs of long sales that occur on T+4; and

(2) permit participants to close-out open fail positions throughout the trading session on the Close-Out Date (and not only at the open of trading).

IV. Disregard of Market Standard Notifications

The proposed regulations do not include any provisions related to buy-in notification or other communication during the DTC settlement cycle. We note in this regard that certain firms have taken the position that the SEC's temporary emergency close-out rule supersedes all existing best market practices. This has resulted in an unfortunate and in our view, avoidable increase in transactional, operational and market costs. Due to the lack of clarity around notification requirements, and the severe penalties for non-compliance with the new rules, many market participants are disregarding long-standing market best practices with respect to pre and post buy-in notification. Indeed, some market participants now interpret Rule 204T to supersede previous market practices that were followed by all market participants. In practice, the lack of uniformity in how buy-in notices are provided to investors and in the amount of time provided between buy-in notices and buy-ins has resulted in market confusion.

Recommendation: The RMA urges the SEC to provide for pre and post buy-in notifications similar to those previously followed which were based on FINRA Rule 11810, as well as an amendment to Rule 204T of Regulation SHO to provide for the following:

(iii) written pre-notice of "buy-in" to be delivered to the seller 24 hours prior to the execution of the proposed "buy-in"; and

(iv) Notice of close-out to be delivered immediately but not later than 4:30 pm Eastern Time on date of execution to seller with all pertinent details (account number, asset identifier, number of shares, net amount of original transaction, original trade date, buy-in execution price, buy-in execution net amount and settlement date of the actual buy-in.

In closing, the RMA supports the SEC's effort to combat persistent fails to deliver and abusive naked shortselling. We would also like to emphasize the key role played by securities lending in promoting efficient and liquid markets, and in minimizing fails to deliver -- the very purpose of Rule 204T. As discussed above, we believe that the current requirements of Rule 204T have created unintended and negative consequences for beneficial owners that, if not corrected, will result in a withdrawal from the securities lending market by many beneficial owners. This will in turn have far greater negative consequences for liquidity and the rate of fails to deliver than the intended benefits of the Rule. The amendments proposed above would reduce the additional and unintended risks to participants in the securities lending market, without diminishing the strength of the rule to address naked short sellers, who are the primary focus of the Rule.

Sincerely,

Michael P. McAuley

Michael P. McAuley, Chair, RMA Committee on Securities Lending

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, Division of Trading and Markets
Andrew Donohue, Director, Division of Investment Management
Curtis H. Knight, Director, RMA Securities Lending/Market Risk