January 19, 2009

Ms. Florence E. Harmon
100 F Street, NE
Washington, DC 20549-1090

Re: Amendments to Regulation SHO, Interim Final Temporary Rule; S7-30-08

Dear Ms. Harmon:

To those in the Division of Trading and Markets who will be required to draft proposal for this new rule, the language in the reference below is that of a proposed rule change presented to the SEC in March of 2004. This proposed language was a parallel action being undertaken by the NASD to address short sale delivery failures at a time in which the Commission was considering the adoption of Regulation SHO and was seeking public input on their proposal.

> *(b) If delivery cannot be made within 10 business days after settlement date, the clearing firm must, at a minimum, have taken affirmative steps to make delivery and must continue to engage in such affirmative steps until delivery is completed. Price or cost concerns associated with borrowing or buying in the securities would not be an acceptable basis for non-compliance with paragraph (a) of this rule. Further, the clearing firm must document the affirmative steps taken to make delivery and why delivery has not been made within the requisite time period and report this information to NASD within one business day of its failure to satisfy the 10-day delivery requirement. The clearing firm must continue to document and report such information to NASD for each business day until delivery is made.*[1]

At the time that the NASD presented this proposal Mary Shapiro was a high ranking executive of the NASD. In such a position, Shapiro would have had to agree with this proposal prior to its submission to the Commission. Unless some unforeseen event transpires, this will be the same Mary Shapiro who will be confirmed as the next Chairman of the Securities and Exchange Commission.

I raise this point as significant based on a past that is forever captured in regulatory filings.

Since June 2004 and the first release of short sale reforms, the Division of Trading and Markets has specifically factored price and cost considerations into their proposed and released reforms despite the concerns identified by a Shapiro led NASD. To insure the efficiency of work product and resources it may be necessary for the Division of Trading and Markets to understand the views of Ms. Shapiro before focusing efforts in a direction that is not in line with where her administration intends it to go.

Point of reference:

> *"Ms. Schapiro said that she met with Mr. Cox last August and told him that there had been "a migration" of professionals out of more tightly regulated brokerages to less-policed investment-advisory firms.*
>
> *"The SEC has not shared our view that this is something to be concerned about," she said.*[2]

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1 File No. SR-NASD-2004-044 Proposed Amendments Relating to Short Sale Delivery Requirements March 9, 2004

2 Neil Roland Investment News "Schapiro: I'll 'take the handcuffs' off enforcement" January 15, 2009

It is clear by the history of recent reforms that the Commission has similarly not shared the views of a Shapiro led NASD relative to the requirements for settlement in the short sale process. As the Commission continues to seek input from the firms engaged in short selling, leniency is placed on 'prompt and accurate' settlement of securities in order to protect the sellers from what they claim to be cost or pricing burdens.

> *"It would be very costly and operationally burdensome for such a fund to reconcile its trades and update its books and records, among other things, if its clearing broker closes out a large number of the trades placed with it."*[3]

Costly and operationally burdensome to be forced to close out positions in which the short sale process was not conducted under the general guidelines of regulatory rulemaking? Why should the costs of the short seller be placed higher in the pecking order to the cost burdens of the investor who met the standards of trade by making the capital available on-time for receipt of settlement?

Under similar logic, the MFA admits that settlement failures carry a burden in themselves to hedge funds.

> *"MFA members have strong incentives to prevent failures to deliver from occurring. Securities that fail to deliver are disruptive to a fund's trading program because they interfere with a fund's risk management calculation and introduce another layer of uncertainty—the risk of being closed-out."*[3]

Has the MFA considered what risks fails to deliver impose on others who the MFA does not consider a member and who are not trading on a program? Shouldn't such be considered? Similarly, if such risk exists, what logic is there in rationalizing the trading activities that create such failures or the rationalization to extend the amount of time allowed to close such a failure out? In a fluid market such as the US Capital markets does a closeout action change if it is closed out on day 3, day 4, or day 5? If such a condition exists, would it not exist because the investor would choose to close out the fails in smaller lots by day than trades that created the fails?

The contradiction in this comment memo is exactly the concern that the NASD raised before the Commission in 2004. A concern that future rule making proves was being ignored. Price or cost factors can not be considered when closing out a fail to deliver because it is the fail itself that is the burden to the safety of all who are trading within that market. Ultimately it is the fail that brings inefficiency in price discovery and thus it is the fail itself that the Commission must engage policy to eradicate.

The MFA has admitted that the fail is a burden to the markets and their decision to let the fail persist for a longer period of time seems foolish and contradictory. I suggest that instead of focusing on extending the duration of a fail, the MFA should focus energies on insuring that the fails are never considered part of the market trade platform.

How does more time in settlement aide the market? To what benefit does such a fail provide and to whom specifically? If there is such a cost benefit to the investor, it comes by way of a declining market so how does a fail that persists for a longer period of time close more profitably without some market inducements for further decline? Would such inducements be price efficiency or market manipulation?

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[3] Managed Fund Association memo

I suggest that the mandatory pre-borrow would provide the necessary relief that investors, issuers, and the MFA agree is necessary. A mandatory pre-borrow would eliminate the fail and thus eliminate the burden each identifies exists today. The mandatory pre-borrow will likewise insure, as the NASD proposed in 2004, that price and cost will not be used as a factor in settlement failures. By default the failure should not exist if a mandatory pre-borrow was executed properly.

The MFA and the short sale community have expressed that a mandatory pre-borrow is a cost burden to their trading strategy and that such a burden will likewise slow down their trade activity. This too is contradictory when you dig deeper into the short sale process.

Consider that if a locate can be used for a short sale execution a borrow can likewise be achieved for that same short sale. If you locate it you can borrow it. If you can locate it but can't borrow it that is a necessary red flag to an impending fail to deliver and the trade should not be executed.

For example, if a firm is using the easy to borrow list there should be little concern for operational delays in the execution of a short sale. Engaging in a contract to borrow for shares from a vast inventory of available shares should be a process streamlined in today's markets. If such delays exist it is not due to the trade but due to the legitimacy of shares available to borrow.

If, however, the seller is shorting a security that is considered "hard to borrow" one would expect operational delays based of the current status of such a market and would expect that longer due diligence be taken in the execution of a trade. The seller would have to locate and enter into a contract to borrow a share that may not be easily accessible. This would be a process that must be taken to insure the integrity of the trade itself and to insure that the intent of 15c3-3 is being fully met.

Rulemaking policies that allow for a trade first seek forgiveness after method of trading is illustrating the very loopholes that create securities violations and market abuses. Regulators have a tough enough time identifying fraud without having to prove that an intended fail was not simply a human error which is why so many fails existed for as long as they have. Regulators could not make the cases.

The mandatory pre-borrow tempers the short sale activities in a highly sold market based on the pre-existing condition of that particular market by those investors who had acted more swiftly. Such hurdles under these conditions insure a higher quality of price discovery without volatility.

The present market practice of locating a share the investor does not expect to be available for delivery is essentially agreeing to the fact that there will be a high probability that the short sale will enter into a settlement failure. We all agree this is burdensome. Such practice makes the stand alone locate, without a borrow, meaningless as the foundation of a share behind the trade is not being supported.

> *Under the Emergency Order, before undertaking a short selling strategy, a market participant must consider in advance the costs and risks of ensuring with 100 percent certainty that enough shares will be available to cover the maximum number of shares that may be sold short throughout the duration of the strategy. Moreover, the market participant must compete for suddenly scarce stock borrow with all of the other market participants who are conservatively borrowing substantial amounts of stock to avoid any risk of violating the rule, and with market participants who can easily squeeze shorts by pulling scarce stock borrow from the market.*[4]

[4] Comment Memo James Chanos (CIPC) and Richard Baker (MFA) in response to July 2008 Emergency Order S7-20-08 placing a mandatory pre-borrow on a limited number of securities.

The members represented by the MFA and Mr. Chanos himself are not market novices. Nothing contained in this dialogue should be new to these individuals and thus the Commission should not treat this as some surprise that has only now created burden to the particular participants.

Those opinions represented by this memo have participated in these markets long enough to understand that every trade executed by every market participant, long or short, comes with risk and that risk should be evaluated up front before executing a trade. This is what is called due diligence. Similarly each trade executed, long or short, is and will always be a competition between market participants. Not every market order can be filled at the market price represented when the order was entered. There needs to be adequate supply for the demand at that price. Many believe that the abusive short selling is exactly a tool to distort such markets by creating opportunity (supply) for buyers at prices natural sellers would not participate.

Finally, with regards to the concern that shares are being borrowed as a means of locking out short sellers, this is an issue that may require additional regulation and something the Commission should consider. The rigging of a market, whether long or short, is neither healthy nor efficient. If short sellers are aware of such activity they should approach the Commission about it and not expect the Commission to simply accept lesser laws because of it.

To place burdens and risk into the capital markets at the risk and safety to a majority of investors simply to reduce cost burdens that the short seller should already be factoring into their trades is ill advised. In our markets today, with high volume and efficiencies in the trade settlement system, there should be no excuse for fails to take place at any level of regularity. Fails that do happen for unforeseen reasons should be an exception and not the rule and those exceptions should be handled as such.

The Division of Trading and Markets would be negligent if the next round of rules continues to throw the baby out with the bath water. Making exceptions standard allows the abuses to enter freely and without fear.

With the near consensus that Mary Shapiro will become the next Chairman, focus today on what she and her staff presented the SEC in the past. Cost can not be a factor in the execution of trade settlement.

David Patch