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September 26, 2007

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: File No. S7-19-07

Ladies and Gentlemen:

We submit this letter on behalf of our clients, BNY ConvergEx Execution Solutions LLC, ITG Inc., Oppenheimer & Co. Inc., National Financial Services LLC, NYFIX Inc., Pershing LLC and RBC Capital Markets Corporation (collectively, the "Commenting Firms"), in response to a request by the Securities and Exchange Commission ("SEC" or the "Commission") for comments on Securities Exchange Act Release No. 34-56213,[1] which proposes amendments to Regulation SHO under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Our comments are limited to the proposed amendment to the long-sale marking provisions of Regulation SHO that would require broker-dealers designating a sale as "long" to document the present location of the securities (the "Proposed Amendment"). We appreciate the opportunity to comment on the Proposed Amendment.

I. Background

Regulation SHO effected significant changes in the regulation of long and short sales, including, among other things, changes relating the marking of order tickets.[2] Regulation SHO has no documentation requirement for long-sale order tickets, but provides that broker-dealers may mark an order to sell "long" only if the seller is deemed to own the securities being sold pursuant to paragraphs (a) through (f) of Rule 200,[3] and either the security is in the physical possession or control of the broker-dealer, or it is reasonably expected that the security will be in the physical possession or control of the broker-dealer, on or before the settlement date. This means that the broker-dealer must determine that the

[1] Exchange Act Release No. 34-56213, File No. S7-19-07 (August 7, 2007), 72 Fed. Reg. 45558 (August 14, 2007) (the "Release").
[2] Exchange Act Release No. 34-50103, File No. S7-23-03 (July 28, 2004), 69 Fed. Reg. 48008 (August 6, 2004) (the "Adopting Release").
[3] *See* 17 CFR §§ 242.200(a) through (f).

customer is "deemed to own" the securities the customer proposes to sell before it marks a sell order long.

Prior to the adoption of Regulation SHO, broker-dealers had similarly limited obligations. Former NASD rule 3370(b)(1)(A) through (D) prohibited member firms of the National Association of Securities Dealers, Inc. ("NASD") from accepting an order to sell long unless: (A) the member firm had possession of the security; (B) the customer was long the security in his account with the member; (C) the member firm or associated person made an affirmative determination that the customer owned the security and would deliver it in good deliverable form by the settlement date; or (D) the security was on deposit in good deliverable form with another broker-dealer or a bank and instructions were given to that bank or broker-dealer to deliver the securities against payment. Former NASD rule 3370(b)(4)(A) made clear that, to satisfy the "affirmative determination" requirement in sub-section (C), the member firm or associated person had to detail on the order ticket the conversation with the customer as to the present location of the securities and whether the customer owned the securities and would deliver them in good deliverable form by the settlement date. By citing specifically to sub-section (C), former NASD rule 3370(b)(4)(A) made clear that there was no order ticket marking requirement if the member firm relied on sub-section (A), (B) or (D) when it accepted an order to sell long.

Regulation SHO was widely understood to replace former NASD rule 3370(b) in its entirety. Indeed, the Adopting Release made clear that one of the primary purposes of Regulation SHO was to implement a uniform regulatory standard governing long and short sales that would eliminate "overlapping SRO rules."[4] Consistent with such objectives, the NASD repealed former NASD rule 3370(b) in December of 2004.[5] The repeal was made effective on January 3, 2005, the effective date of Regulation SHO.[6]

Several months later, the NASD reversed course and tried unsuccessfully to summarily impose documentation requirements on long-sales that were significantly more onerous. The new provision, filed for immediate effectiveness as a "non-controversial" amendment under section 19(b)(3)(A) of the Exchange Act, was purportedly a "re-adoption" of former NASD rule 3370(b) that was intended to "clarify" pre-existing obligations.[7] It was, in fact, neither a re-adoption nor a clarification. The new NASD rule 3370(b) created significant new documentation requirements for important categories of orders that had previously been

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[4] Adopting Release, at 48014.
[5] *See* Securities Exchange Act Release No. 50822 (Dec. 8, 2004) 69 Fed. Reg. 74554 (Dec. 14, 2004); NASD Notice to Members 04-93.
[6] *See id.*
[7] Securities Exchange Act Release No. 52131 (July 27, 2005), 70 Fed. Reg. 44707 August 3, 2005) (the "Re-Adopting Release").

exempt from the rule.[8] Such categories of orders included: (1) securities that are on deposit with a bank or broker-dealer; (2) securities that have been hypothecated by a member firm; and (3) securities for the account of a broker-dealer that is not an NASD member firm.

Several of the Commenting Firms challenged the new provision, urging the Commission to exercise its authority to summarily abrogate the new provision under section 19(b)(3)(C) of the Exchange Act. Abrogation was appropriate because the new NASD rule 3370(b) made substantive changes to former NASD rule 3370(b) that should have been subject to a formal rulemaking. Even in the absence of substantive changes, abrogation was appropriate because Regulation SHO was intended to govern all aspects of long and short sales. The fact that Regulation SHO does not contain identical provisions to the former NASD rule 3370(b) does not mean that former NASD rule 3370(b) was not meant to be supplanted in its entirety. Neither the NASD nor any other self-regulatory organization ("SRO") can "re-adopt" standards that are inconsistent with Regulation SHO without engaging in a formal rulemaking.

The SEC agreed. On September 14, 2005, the SEC summarily abrogated the new NASD rule 3370(b).[9] The SEC concluded that abrogation was "appropriate in the public interest, for the protection of investors, and otherwise in furtherance of the purposes of the Exchange Act."[10] The NASD took no further action with respect to the abrogated provision. The issue did not resurface until the Proposed Amendment.

On August 7, 2007, the Commission proposed for further comment an amendment to the long-sale marking provisions of Rule 200(g)(1) of Regulation SHO that would require broker-dealers marking orders to sell "long" to document the present location of the securities being sold. This is, once again, a significant expansion of the prior standard. Like the abrogated NASD provision, the Proposed Amendment would create onerous documentation requirements for important categories of orders that had been previously exempt from the rule. This includes, most significantly, delivery-versus-payment ("DVP") transactions. Most institutional customers use an agent bank or prime broker to custody their securities while directing orders in DVP accounts to a wide variety of executing brokers.

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[8] New NASD rule 3370(b) provided that:

> "to the extent a member or person associated with a member does not have physical possession or control of the securities, the member or person associated with a member must document, at the time the order is taken, the communication with the customer as to the present location of the securities in question, whether they are in good deliverable form and the customer's ability to deliver them to the member by settlement date."

[9] *See* Securities Exchange Act Release No. 52426 (Sept. 14, 2005).

[10] *See id.*

Under the former NASD rule 3370(b), and currently under Regulation SHO, broker-dealers can accept long sales from DVP customers based upon a "reasonable belief" that the securities being sold are on deposit with an agent bank or prime broker and will be delivered by the customer in good deliverable form by the settlement date. The executing broker is not required to compile and record custodial information in advance of each order to sell "long" in a DVP account. Provided the customer has DVP instructions on file with the executing broker, executing brokers can form a "reasonable belief" that the securities being sold are on deposit with a custodian based upon a pattern or practice of timely delivery. This enables institutional customers to enter long-sale orders quickly and efficiently, a matter of supreme importance in fast-moving markets. The Proposed Amendment is a dramatic departure from this streamlined process.

II. Discussion

A. The Proposed Amendment Fundamentally Changes the Order Entry Process for Long-Sale Orders in DVP Accounts

The Proposed Amendment would force executing brokers and their customers to make fundamental changes to the process of accepting and entering long-sale orders in DVP accounts. Determining the "present location" of securities held by an institutional customer for DVP delivery is a complex process that is far more difficult than it might appear. It is not uncommon at all for money managers to trade on behalf of multiple institutional customers, each of which may have multiple custodians.

Set forth below is a step-by-step description of a typical long-sale order from an institutional money manager in a DVP account under the proposed regime:

Step 1: The portfolio manager of an institutional money manager submits an instruction to the buy-side trader to sell a security long.

Step 2: The buy-side trader begins electronically submitting sell orders to one or more executing brokers, which request, electronically or otherwise, information from the buy-side trader regarding the present location of all securities.

Step 3: To determine the present location of the securities being sold, the buy-side trader requests a breakdown from the portfolio manager that identifies: (1) the underlying accounts that are expected to receive a portion of the execution; (2) the percentage or amount of shares that each underlying account is

expected to receive; and (3) the custodian for the shares held in each underlying account.

Step 4: With the assistance of back-office personnel of the institutional money manager, the portfolio manager prepares a list of the underlying accounts that are expected to receive a portion of the execution, and calculates the percentage or amount of shares that is expected to be allocated to each underlying account. Once the list and allocations are generated, the portfolio manager requests other back-office personnel to identify the relevant custodian for the shares held in each of the underlying accounts.

Step 5: The portfolio manager transmits to the buy-side trader a breakdown that identifies: (1) the underlying accounts that are expected to receive a portion of the execution; (2) the percentage or amount of shares that each underlying account is expected to receive; and (3) the custodian for the shares held in each underlying account.

Step 6: The buy-side trader transmits the breakdown information to the executing broker.

Step 7: The executing broker records the breakdown information on the order ticket before routing the order to the appropriate market center for execution.

As the above scenario demonstrates, determining the present location of securities held by institutional customers can be a complex, difficult and time-consuming process. Indeed, some institutional money managers have hundreds of underlying accounts that may receive an allocation on a single block trade. As it stands now, institutional customers take several hours to compile and record allocation information for the executing broker after executing a typical order. The Proposed Amendment would force institutional money managers and executing brokers to undertake these efforts before they can enter an order to sell long. This is a very substantial burden that would impose substantial changes to the ordinary process by which buy-side money managers enter orders. Beyond the additional costs, it would materially slow the order-entry process.

The potential benefits are far less clear. The Proposed Amendment makes no exception for an executing broker's "reasonable belief" that the securities being sold are on deposit with an agent bank or prime broker. The executing broker is instead required to obtain allocation and

custodial information in advance of accepting each DVP trade, regardless whether the DVP client has ever failed to deliver on a long sale. Thus, if a buy-side trader places a dozen long-sale orders in a DVP account during the trading session, the executing broker must undertake the same inquiries again and again. This remains true even if the institutional customer has an unblemished record of delivery — indeed, even if the institutional customer manages only long accounts and never engages in short-selling activity. The institutional customer, in the meantime, sits on the sidelines (and risks "missing the market") because it cannot effect a long-sale until it can determine and provide the executing broker with the custodial information that the executing broker will be required to record on the order ticket.

The Proposed Amendment makes changes to the process by which executing brokers and their institutional customers enter and process orders that are far greater than the Staff has acknowledged in the Release. These extensive changes will sharply increase the amount of time and money that it will take institutional customers to effect long-sales. This will result in, among other things, decreased liquidity in the marketplace. The Staff should not adopt the Proposed Amendment without exhaustively considering the significant adverse impact it will have on executing brokers and institutional customers.

B. The Staff Vastly Underestimates the Compliance Burdens for Executing Brokers and Ignores the Costs that Will Be Imposed on Institutional Money Managers

The Staff's estimates on the compliance burdens imposed by the Proposed Amendment are based upon misguided assumptions about the extent to which executing brokers can automate the process of documenting the present location of securities being sold. Using the number of trades executed annually, the Staff calculates that each broker-dealer is likely to spend approximately 49 "burden hours" per year (355,114 per trades for each firm, multiplied by .5 seconds per response).[11] The Staff throws in an additional $1,072 for each broker-dealer — 16 hours of programming at $67 an hour — to account for the costs of reprogramming systems to comply with the new requirements.[12]

The Staff's estimates are based upon an assumption that the process for complying with the Proposed Amendment will be highly-automated with respect to every type of order. Based upon this assumption, the Staff concludes that broker-dealers will need only a half of a second to document the present location of securities being sold. The Staff's assumption and conclusion appear to assume that broker-dealers can automate the recording of information that they do not, in fact, possess at the time of order entry. For many long-sale orders in DVP accounts, the process of obtaining, compiling and recording custodial information

[11] Release, at 65.
[12] Release, at 65-66.

cannot be done in a few minutes, let alone half of a second. The process may involve several people compiling allocation and custodial information from various sources on the buy-side. It is speculative to estimate the amount of time that it would take executing brokers to comply with the Proposed Amendment without having considered the amount of time it will take buy-side firms to obtain, compile and transmit such information to the executing broker. It will vary substantially, and it will depend on, among other things, the institutional customer, the number of underlying customers accounts to which an order may be allocated, the number of custodians per order, and the ability of the money manager to completely redesign its order-management systems to perform the account allocation and identify the custodian for each such account prior to order entry. We are aware of no system that can magically automate this process for all types of long-sale orders.

Even when a DVP customer has a single custodian, the process of recording the custodian on the order ticket does not appear to be something that can be done in less than a second. The executing broker cannot simply mark the order ticket by checking a box (or "clicking" a button). The executing broker must record the present location of the securities being sold. This means that the sales trader or the institutional money manager must input the custodian's name, or some other custodial identifier, on the order ticket. There is no default custodian. This, too, takes more than a half of a second.

To support its determination that a half of a second is an appropriate timeframe, the Staff draws analogies to other marking requirements imposed by Regulation SHO. The Staff points out that:

(1) half of a second was determined to be an appropriate timeframe for a broker-dealer to mark an order "long," "short," or "short exempt";[13] and

(2) broker-dealers should already have similar systems in place to comply with the "locate" requirement in rule 203(b)(1) of Regulation SHO,[14] which requires them to document when effecting a short-sale that they have (i) borrowed the securities, or entered into a bona fide arrangement to borrow the securities, or (ii) reasonable grounds to believe that the securities can be borrowed so that they can be delivered on the delivery date.

Each of these analogies is readily distinguishable. Marking an order "long," "short," or "short exempt" is very different from documenting custodial information. The

[13] Release, at 65, n.115.
[14] Release, at 65, n.115.

broker-dealer is not required to obtain or compile information, or input any information on an order ticket. The broker-dealer simply chooses among three pre-designated options. The "locate" requirement in rule 203(b)(1) is a similarly narrow marking requirement. The broker-dealer need only determine whether a borrow has been effected or arranged (yes or no), and, if not, whether there are reasonable grounds to believe that the securities can be borrowed (yes or no). Here again, the broker-dealer simply chooses between pre-designated options. These marking requirements — which may well be effected in a very short timeframe — stand in stark contrast to the long-sale marking requirements in the Proposed Amendment. Custodial information can rarely, if ever, be recorded in a fraction of a second.

The "locate" requirement in rule 203(b)(1) is a fundamentally different obligation in any event. Most broker-dealers determine that they have "reasonable grounds" to believe that the securities can be borrowed on or before the delivery date in one of two ways. A broker-dealer may determine that it has "reasonable grounds" to believe that the securities can be borrowed based upon a representation from a customer that it has an away-locate. A broker-dealer may also determine that it has "reasonable grounds" to believe that the securities can be borrowed when the securities appear on an easy-to-borrow list, which are available to broker-dealers electronically. In either case, it is a simple inquiry. The institutional customer has an away-locate or not. The securities appear on an easy-to-borrow list or not. The Proposed Amendment requires an entirely different kind of inquiry that does not depend on whether the securities are available to the institutional customer or the broker-dealer. The institutional customer must actually be long and the broker-dealer must determine the identity of the custodian that holds the long position. This is not at all similar to the "locate" requirement in rule 203(b)(1).

The Staff's estimate of the burdens also ignores what is likely to be the far greater expense indirectly imposed on institutional money managers. Executing broker-dealers must necessarily "push" the burden of determining the present location of securities sold long in a DVP account on to their institutional money manager clients. As discussed above, executing brokers do not have ready access to custodial information for the underlying accounts of their institutional customers. This information must be compiled, recorded and transmitted by money managers, portfolio managers, and back-office personnel. Each underlying account has its own custodian or custodians, which may differ based upon the securities being sold. Compiling, recording and transmitting such information to executing brokers in advance of each long-sale order is a time-consuming and difficult process that will impose significant costs on institutional investors (and that will, in all likelihood, be passed on to individual investors). The Staff should not ignore these costs and burdens when it estimates the compliance burdens of the Proposed Amendment. Such costs and burdens will have a significant impact on the ability of institutional customers to enter long-sale orders in a timely and cost-effective manner.

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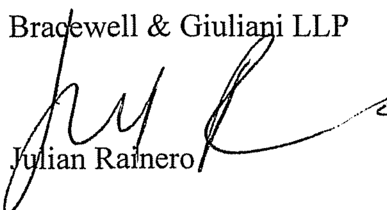
We thank the Commission for its serious consideration of these comments. If you have any questions about this comment letter or need any additional information, please feel free to contact me at 212.508.6142, or my colleague, Bob Frenchman, at 212.508.6184.

Very truly yours,

Bracewell & Giuliani LLP



Julian Rainero

cc: The Hon. Christopher Cox, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Roel C. Campos, Commissioner
The Hon. Kathleen L. Casey, Commissioner
The Hon. Annette L. Nazareth, Commissioner
Dr. Erik R. Sirri, Director, Division of Market Regulation