UBS Securities LLC
677 Washington Blvd.
Stamford, CT 06901
Tel. 203 719-1000

September 22, 2006

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington D.C. 20549-9303

Re: **Securities and Exchange Commission Rel. No. 34-53742; File No. SR-NSCC-2006-04: Proposed Changes to Regulation SHO**

Dear Ms. Morris:

INTRODUCTION

UBS Securities LLC, the U.S. investment banking arm of UBS AG[1], respectfully submits this letter in response to the above release.[2] ("SEC Release") The proposed amendments would eliminate the "Grandfather" provision in Regulation SHO, narrow the options market maker exception to affirmative determination and update the market decline limitation in the exception for certain index arbitrage activities. The SEC Release also raises a number of specific questions concerning the current operation of Regulation SHO and seeks comment on those issues. On September 19, the Securities Industry Association ("SIA") filed a comment letter discussing the various issues raised in the SEC Release.[3] ("SIA Comment Letter") We participated in the drafting of that letter and have shared our views with that group. We generally agree with and support the points in the SIA Comment Letter. In particular, we agree with the SIA view that based on the limited universe of securities where fails represent a problem, the Commission should not, without careful consideration, impose additional requirements in Regulations SHO that could negatively impact the efficient operations of the securities markets. We are filing this letter to reiterate and expand on some of the points made in that letter.

---

[1] UBS AG is one of the largest financial institutions in the world serving a diverse client base ranging from affluent individuals to multinational institutions and corporations. The firm has 87 stock exchange memberships in 31 countries, and is widely acknowledged as a leader in the secondary equity trading markets. In the U.S., the firm is active in all of the equity, fixed income and option markets. It is ranked number 1 in equity trading on the NYSE and NASDAQ markets. UBS Investment Bank is a business group of UBS AG. UBS Securities LLC is a subsidiary of UBS AG.

[2] Securities Exchange Act Release No. 54154 (July 14, 2006), 71 FR 41710 (July 21, 2006).

[3] Letter from Ira D. Hammerman, SIA Senior Vice President and General Counsel to Ms. Nancy M. Morris, Secretary, Securities and Exchange Commission, dated September 19, 2006.

DISCUSSION

We commend the SEC attempt to bring greater clarity to the provisions of Regulation SHO. We support the proposed changes regarding option market makers and the index arbitrage exception. We oppose, however, the proposed change to the grandfather provisions of Regulation SHO since we believe that removing the grandfather provisions will cause substantial market disruption by increasing significantly the number of buy-ins in the market without sufficiently targeting abusive naked short sellers. We also comment below on certain of the interpretive questions raised in the SEC Release.

COMMENTS ON SEC PROPOSALS:

1. **Proposal to Limit Option Market Maker Exception:** The SEC Release would maintain but limit the exception for option market makers by requiring the market maker to close out short stock positions that remain open after the countervailing option positions have been closed. We generally agree with this proposal. We support the Commission decision to maintain the exception from the close-out requirement for option market makers, since the exception helps market makers facilitate customer transactions. We believe that a potential abuse of this exception will be avoided when option market makers are required to close out stock positions when the option position is closed. We are concerned, however, that this change will require firms to implement systems changes to track these requirements and ask the Commission to be sensitive to the time necessary to make these changes. We are also concerned that the Commission apply this rule in a practical manner recognizing that small delays in closing out positions will occur in the normal course of business, i.e. after expiration or close out of the option position. More importantly, it may be impractical, if not impossible, to track individual hedge transactions to specific option transactions. For example, a delta hedge of 50% against two open option positions in the same stock would not necessarily be closed if one of the option positions were closed. Rather, overall stock positions should be compared to open options positions to determine whether the exemption continues. In the above example, the stock position would still be a hedge against the remaining open option position and should not be required to be closed. On the other hand, if both open option positions were closed, then the stock position would become subject to the Reg. SHO close out requirements.

2. **Proposal to Eliminate the Grandfather Exception:** The SEC Release proposes eliminating the grandfather provisions of Regulation SHO. The effect would be that pre-existing fail positions before a security became a threshold security would be subject to the thirteen day buy-in and pre-borrow requirements of the rule. We believe that removing the grandfather exception will cause substantial market disruption by increasing significantly the number of buy-ins in the market without sufficiently targeting the abusive naked short sellers. And, it would penalize market participants who legitimately rely on an exception from the "locate" requirement prior to the stock becoming a threshold security. More targeted approaches, such as tracking actual naked shorts, would be a more appropriate method of addressing this issue. If the Commission were still determined to remove the exception we would recommend an approach similar to that contained in the SIA letter, where buy-in requirements buy-in period for grandfather positions be set at 35 days for all

future fail positions existing when a security becomes a threshold security, and not just those grandfathered positions in place when the rule is adopted, in order to minimize market disruption going forward.

3. **Proposal to Update the Index Arbitrage Exception.** We support the Commission's proposal to update the index arbitrage exception to reference the NYA instead of the DJIA, for purposes of the market decline limitation in Rule 200(e)(3).

COMMENTS ON INTERPRETIVE QUESTIONS:

In addition to proposing specific changes to Regulation SHO, the SEC Release raised a number of additional questions regarding the implementation and operation of Regulation SHO. We address certain of those questions below. We urge, however, that if the comments on any of these issues warrant further changes to Regulation SHO, the SEC issue a subsequent release proposing those changes and seeking specific comment on those proposals before adoption.

1. **Rule 144 Restricted Stock:** The SEC Release seeks comment on whether an exception from the thirteen day buy-in requirement should be granted for securities sold long pursuant to Rule 144 but which do not settle in the thirteen day period because of delays in the process of transferring the securities. We believe that Rule 144 restricted stock transactions should be excluded from threshold security since they reflect legitimate long sale transactions that fail to settle within the appropriate time frame only because of the time necessary to transfer the securities. They do not reflect any of the abusive short sale transactions targeted by Reg. SHO since the seller has an ownership position in the security being sold thus no incentive to depress the price of the security. These transactions should not be included in the calculation of fails that would trigger threshold security status. They should not be included in the T-13 calculation for determining whether the restriction applies to the firm. And, they should not be counted when determining particular buy-in requirements. Fails outstanding more than 35 days would be included in the above calculations and trigger the above requirements.

   This is particularly important in light of the Division of Market Regulation's interpretation in Q&A 5.8 of the Division's *Frequently Asked Questions Concerning Regulation SHO*, which states that any reductions in a participant's CNS fail position in a threshold security must be applied on a last-in-first-out ("LIFO") basis. Under the methodology prescribed in Q&A 5.8, any deliveries of clean shares must be applied to the participant's most recent increase in its CNS fail position, while the participant's older fail positions continue to age. The net result is that firms may be forced to effect buy-ins even in situations where stock has been made available for delivery. And, due to the nature of 144 sales, these buy-ins may generally be for sizeable quantities of stock, and thus bear the risk of causing severe disruptions in the market for such threshold securities, which are generally otherwise very illiquid. We also urge the Commission to take the opportunity to reconsider the application of Q&A 5.8 in other circumstances where the LIFO methodology causes unusual results with potential disruptive market effects.

2. **ETF's and Other Similar Securities:** The SEC seeks comment on whether ETF's should be excluded from the threshold security list since they are unique securities that represent a

basket of underlying securities. We support this suggestion. ETF's are not vulnerable to the naked short selling practices that affect other securities. Also, there is a ready source of this security through buying the underlying securities and delivering them to create the ETF. This exception should be extended to other securities that represent baskets of underlying securities such as muni-trusts and closed end funds.

3. **Borrow to Clean up Fail Position on Day 13:** The Commission asked whether borrowing, rather than purchasing securities, to close out a position would be more effective in reducing fails to deliver, or could borrowing result in prolonging fails to deliver. We believe that borrowing to close out a fail position should be permitted in order to allow for more efficient close out of fail positions without negatively impacting the market for the security through excessive purchases in the market. Borrowing securities furthers the purposes of Regulation SHO closing out the fail position while not having the same impact on the market as potential buy-ins. And, we do not believe that borrows will prolong fails to deliver. Arranging the borrow and delivering the securities should close out the fail position. Naked short sellers will still be forced to close out naked short positions if the stock is not available for borrow.

4. **Individual Tracking of Fail Positions for Buy-in Purposes:** The Commission questioned whether in light of recent developments it should change its view on the individual tracking of fail positions. We believe that certain firms are now capable of individual tracking of fail positions so that naked short sellers could be identified in many, if not all cases. We believe that the T-13 buy in requirements should be changed to accommodate this methodology, which could replace the current LIFO philosophy articulate in SEC *Q & A 5.8* described above. True naked short sellers would be caught by the process and positions would not be allowed to extend beyond 13 days. Firms that are capable of individual tracking should be allowed to rely on this as an alternative to the current standards. In order to rely on this exception, the firm would have to establish that it could track the actual fail in a particular security and take appropriate action to close out that fail position. This would be a more accurate method than LIFO in tracking buy-in, borrow and other close outs against actual fail positions. However, since all firms do not currently have the capacity to track individual fails, those firms should be allowed to fall back on the current regulatory standards.

5. **Percent Required to Trigger Threshold Status:** The Commission asked whether the current standard of ½ % of securities failing to trigger threshold status was the right level. We believe that the ½% standard is too low and encompasses too many situations where there are no significant delivery issues. The percentage should be increased to 2%. This would exclude borderline securities where there is no significant delivery issue but would include particularly troublesome securities. This higher cutoff would substantially decrease the burden on the industry and the potential disruptive effect of excessive buy-ins. The ½% threshold allows for the risk of arbitrage and for manipulation of the market by causing short squeeze opportunities. The higher threshold would avoid these problems while still targeting abusive naked short sale positions.

6. **Uniform Extended Fails Proposal:** The Commission questioned whether a standardized T-13 restriction should be applied across the industry in certain securities rather than the current method of tracking fails in threshold securities and applying the pre-borrow and buy-in

requirements at each individual firm. We believe that a uniform extended fails proposal would not be good for the market. The entire industry would be subject to restrictions caused by the delivery problems and issues caused by one or a limited number of firms. Firms that had no open fail positions would be subject to the pre-borrow requirements simply because a particular firm or a small group of firms failed to meet its obligations. Moreover, firms have already established procedures to track fails and apply the restrictions, thus the cost benefit of such a general procedure would now be minimal.

7. **Requirement to Decrement Share Positions when Giving Affirmative Determination:** The Commission raised for comment the concept of requiring broker-dealers, in determining compliance with the locate requirement, to only rely on lenders that decrement their available borrow. We believe that requiring firms to make affirmative determinations only at firms that decrement positions would not achieve the goals of the rules. These circumstances all encompass individuals who actually made an affirmative determination, thus the rule is not targeted to abusive naked short sellers. Also, the affirmative determination process in institutional trading firms is disconnected from the actual delivery process. An affirmative determination may be given by one firm, but actual settlement and delivery may be made by numerous individual sub-accounts through different custodians. Decrementing may be overly restrictive in that stock may be tied up at multiple locations without any actual or potential use of that stock to fill actual short positions thus severely limiting the scope of available borrow and thus legitimate short sales.

8. **Generalized Disclosure of Fail Positions Should Not be Required:** The Commission raised the question whether the rule should require the disclosure of the amount or level of fails to deliver in threshold securities, and, if so, whether such disclosure should be on an aggregate or individual stock basis. We oppose any requirement that firms publicly disclose their fail positions. Any such requirement would impose a substantial burden on firms to unravel complex trading streams without resulting in any usable information. More importantly, this information is proprietary to the firm and its customers and could result in disclosure of confidential information such as trading strategies. Disclosure could also expose customers and firms to potential short squeeze situations.

9. **Long Sale Annotation Should Not be Required:** The Commission raised for comment whether to incorporate into Reg SHO a requirement for broker-dealers, with respect to "long" sale orders received from customers, to make a notation on the order ticket at the time the order is taken that reflects the conversation with the customer as to the present location of the securities being sold, whether they are in good deliverable form, and the customer's ability to deliver them to the broker-dealer within three business days. This proposal would take a complete revamping of front end systems and does not have sufficient support in the delivery vs. payment market. Firms have already established procedures to assure that trades are appropriately marked long or short. The existing FOS process that tracks fails on long as well as short positions is sufficient to capture firms that are abusing the system by marking sales long rather than short. There is no valid purpose to put an additional burden on the industry.

CONCLUSION

We appreciate the opportunity to comment on the proposed changes to Regulation SHO. We urge the Commission to carefully consider the comments of the industry before making any changes to Regulation SHO. The application of Regulation SHO rules is highly technical with significant potential impact on the markets. The Commission should not impose additional requirements in the Rule that could have unintended consequences on stock lending and clearance and settlement operations, as well as the markets as a whole, without carefully weighing the cost benefit of those changes. Please call the undersigned at 203 719-1511 if you have any questions about this letter or need further information.

Respectfully Submitted,

S/Gerard S. Citera

_____

Gerard S. Citera
Executive Director
U.S. Equities
UBS Securities LLC

CC: Honorable Christopher Cox, Chairman
Honorable Paul S. Atkins, Commissioner
Honorable Roel C. Campos, Commissioner
Honorable Cynthia A. Glassman, Commissioner
Honorable Annette L. Nazareth, Commissioner
Dr. Eric Sirri, Director, SEC Division of Market Regulation
Robert Colby, Deputy Director, SEC Division of Market Regulation
James Brigagliano, Acting Associate Director, SEC Division of Market Regulation
Josephine Tao, Branch Chief, SEC Division of Market Regulation
Ira D. Hammerman, Vice President and General Counsel, Securities Industry Association