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September 19, 2006

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

Re: Release No. 34-54154; File Number S7-12-06
Proposed Amendments to Regulation SHO

Ms. Morris:

The Securities Industry Association ("SIA")[1] appreciates the opportunity to comment on the Securities and Exchange Commission's (the "Commission") proposed amendments to Regulation SHO ("Reg SHO" or the "Rule").[2] The proposed amendments would eliminate the Reg SHO "Grandfather" provision, and narrow the options market maker exception, as well as update the market decline limitation in the Reg SHO exception for certain index arbitrage activities. The Commission also raised in the Proposing Release a number of other questions concerning the operation of the Rule. It is our understanding that the Commission would not be intending to adopt new modifications to Reg SHO relating to the issues raised in these questions at this time, but would rather propose their adoption in a separate rulemaking proceeding. SIA appreciates the opportunity to comment further on any such specific proposals at the appropriate time. In addition, SIA also has provided some initial responses to these questions herein.

I. Introduction

SIA commends the Commission for its efforts to examine the operation of Reg SHO, which has now been effective for approximately twenty months. Reg SHO imposed significant changes on the regulation of short sales as well as, more broadly, broker-dealers' clearance and settlement operations. The SIA agrees with the Commission's statements in the Proposing Release that, by and large, the Rule is having its intended effect without imposing undue impacts on the market. Convincing evidence of these positive impacts was provided in

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1 The Securities Industry Association brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2005, the industry generated an estimated $322.4 billion in domestic revenue and an estimated $474 billion in global revenues. (More information about SIA is available at: www.sia.com.)

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

the Proposing Release, as well as the Memorandum from the Commission's Office of Economic Analysis, dated August 21, 2006 (the "OEA Memo"), relevant excerpts of which are attached hereto as Appendix A.

SIA believes that, in light of the very positive figures cited in Appendix A, and the overall extremely small universe of securities for which settlement failures represent a problem, the Commission should take care to not impose additional requirements in the Rule that could have unintended consequences (including facilitating potential short squeezes and undue price volatility), and negatively impact the efficient functioning of stock lending and clearance and settlement operations, as well as the markets as a whole. Moreover, member firms have incurred significant costs building compliance systems and drafting and training staff concerning policies and procedures designed to ensure compliance with the current Rule.

II. Executive Summary

A. Proposed Amendments

- SIA supports the Commission's decision to maintain the option market maker exception from the close-out requirement, and, while understanding the Commission's desire to re-examine such exception, encourages the Commission to analyze the potential negative implications of amending the exception in the manner proposed.

- SIA also understands the Commission's review of the Reg SHO "Grandfather" provision, however likewise believes that the Commission should consider the extent to which the removal of such provision could potentially facilitate short squeezes and price volatility. To the extent that the Commission believes that such concerns will not be realized, SIA encourages incorporating into the rule a sufficient phase-in period to close-out Grandfathered fails, which should apply whenever a security becomes a threshold security.

- SIA additionally supports the Commission's proposal to update the index arbitrage exception to reference the NYA, instead of the DJIA, and further recommends amending such exception in other ways to ensure complete consistency with NYSE Rule 80A.

B. Additional Questions in the Proposing Release

SIA commends the Commission for raising questions on whether Reg SHO should be amended to address situations where the Rule currently requires broker-dealers to take action, but such action is not intended or necessary to address any identified abusive or manipulative activity. These questions include: (i) whether to exempt from the Reg SHO close-out requirement fails in threshold securities that result from sales of "owned" securities; (ii) whether to exempt ETFs and similar products from the definition of "threshold security" for purposes of the Reg SHO close-out requirement; and (iii) whether to allow clearing firm participants increased flexibility to clean-up fails in threshold securities by borrowing securities, rather than requiring securities to be bought-in.

At the same time, SIA has concerns with respect to a number of other questions included in the Proposing Release. As set forth in greater detail herein, these questions include: (i) whether to require broker-dealers, in complying with the "locate" requirement, to only rely upon feeds received from lenders who decrement the stock they have available to lend; (ii) whether to require broker-dealers to track and close-out fails-to-deliver at the individual account level; and (iii) whether to require firms to annotate, with respect to "long" sales received from customers, the present location of the securities being sold and whether they are in good deliverable form.

III. Specific Amendments Proposed by the Commission

A. Proposed Amendment to the Options Market Maker Exception

The Proposing Release requests comment on amending the exception from the Reg SHO close-out requirement for fails caused by option market makers selling short to hedge option positions that were created before a security became a threshold security. Specifically, the amendment would require that, in the event any such pre-existing option position has expired or been liquidated, all fail-to-deliver positions resulting from such hedging short sales would be required to be closed-out within 13 consecutive settlement days of the security becoming a threshold security or of the expiration or liquidation of the options position, whichever is later. To the extent any such option position has expired on or before the effective date of the proposed amendment, any fails resulting from such hedging short sales would be required to be closed out within 35 settlement days of the effective date of the amendment.

SIA firms support the Commission's decision to maintain the exception from the close-out requirement for option market makers, as such exception provides the ability for option market makers to facilitate customers who wish to purchase and sell options in threshold securities, or securities which bear the potential to become threshold securities. Due to the general difficulty obtaining locates in such hard-to-borrow securities, without such exception many market participants would find it exceedingly difficult to engage in legitimate market activity, such as hedging long exposure in such securities. At the same time, many SIA firms understand the Commission's desire to re-examine the operation of the current option market maker exception. SIA believes, however, that the Commission should be mindful of the potential negative implications of the proposed amendment on the ability for option market makers to engage in bona-fide market making in threshold securities, including situations where market makers are registered in a security which subsequently becomes a threshold security. It is SIA's understanding that such concerns will be outlined in further detail in comment letters that are being submitted by the options exchanges, among others.

Clearing firm participants, however, request the Commission's confirmation that responsibility for determining compliance with the option market maker exception properly rests with such registered option market makers, rather than a firm which is merely clearing the market maker's trades. The issue is one of asymmetry of information – market makers, not their clearing firms, have the information necessary to determine whether their activities are covered by the options market maker exception. If responsibility for compliance were to rest with the clearing firm, then in effect the clearing firm would need to understand, among other things, the market maker's strategy and hedging positions, including its view of factors such as options volatility used by market makers in making hedging decisions. In light of this, it would simply not be practicable, or possible, for a clearing firm to review every single trade executed by each of the potentially numerous market makers for which it clears to ensure such activity was consistent with bona-fide market making activity. Clearing firms should instead be able to reasonably rely upon a firm's designation as a market maker by AMEX, NASDAQ, and/or another exchange in determining whether the market maker's short position was bona-fide hedging its options exposure. This should equally be the case with respect to any new requirements that may be imposed regarding documenting eligibility for the option market maker exception.[3]

B. Proposal to Eliminate the Grandfather Provision

The Commission has proposed to eliminate the "Grandfather" provision currently found in Rule 203(b)(3)(i). In particular, the proposal would require that any previously-grandfathered fail to deliver position in a security that it is on the threshold list on the effective date of the amendment be closed out within 35 settlement days. With respect to any security which becomes a threshold security after the effective date of the amendment, any fails-to-deliver that occurred prior to such security becoming a threshold security would be required to be closed-out within 13 consecutive settlement days. In the event that any Grandfather position was not closed-out within this prescribed time period, under the Commission's proposal the particular threshold security would become subject to the pre-borrow restrictions of Rule 203(b)(3)(iii).

SIA believes that the Commission should carefully consider whether the proposed elimination of the Grandfather provision, while aimed at addressing one form of alleged abuse (on the short side), could potentially give rise to abuse or manipulation on the long side.[4] SIA notes the Commission's statements in the Proposing Release that, "Regulation SHO's grandfathering provision was adopted because the Commission was concerned about creating volatility through short squeezes if large pre-existing fail to deliver positions had to be closed out

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3 In this regard, SIA notes the Commission's question in the Proposing Release regarding whether "a broker-dealer asserting the options market maker exception [should] be required to make and keep more specific documentation regarding their eligibility for the exception…[including] tracking fail positions resulting from short sales to hedge specific pre-existing options positions and the options position…" Proposing Release, 71 FR at 46715. To the extent that the Commission believes the making and keeping of such documentation is necessary and appropriate, clearing firm participants believe that this requirement is and properly should be the responsibility of the registered market maker who is claiming reliance on the option market maker exception, and *not* the firm that is providing clearing services for such market maker.

4 SIA further urges the Commission to consider whether the elimination of the Grandfather provision is necessary in light of the aforementioned data highlighting the very positive impacts of Reg SHO. As stated in the Proposing Release, "[t]he Commission intended to monitor whether grandfathered fail-to-deliver positions are being cleaned up to determine whether the grandfather provision should be amended to either eliminate the provision or limit the duration of grandfathered fail positions." Proposing Release, 71 FR at 46715. The data clearly supports the position that grandfathered fails *are* being cleaned up. Specifically we note OEA's analysis showing that: (i) 99.2% of the fails that existed on January 3, 2005 are no longer outstanding as of March 31, 2006; (ii) only 6 securities have "persisted" on the threshold list since January 10, 2005, and even these 6 securities have seen their fails drop by 68.6%; and (iii) a total of 6,223 securities "graduated" from the threshold list since January 10, 2005, representing 4.5 billion shares in initial fails.

quickly after a security became a threshold security."[5] The Commission has not provided any evidence on why these same concerns do not still exist today, and SIA is concerned that elimination of the Grandfather provision could in fact precipitate a short squeeze in particular threshold securities, thus leading to increased and undue price volatility.[6]

In contrast to the views of some commenters that the Grandfather provision essentially acts as a "pardon" for unlawful and/or abusive activity, SIA believes it is important to note that removing the Grandfather provision could actually negatively impact market participants who had effected sales in reliance on an exception from the "locate" requirement, however the security subsequently became a threshold security. As the Division of Market Regulation Staff has stated specifically in the *Key Points About Regulation SHO* published on the Commission's web site, fails to deliver may often be due to activity for which the Commission has provided a specific exception from the locate requirement (*e.g.*, sales of "owned securities," or bona-fide market making activity),[7] and are therefore not indicative of abusive or manipulative activity. SIA believes that the Staff should proceed cautiously in light of the potentially severe consequences of mandating a buy-in, and include appropriate exceptions for such non-abusive activity.[8]

To the extent that the Commission believes that the benefits of eliminating the Grandfather provision *do* in fact outweigh the costs, SIA urges the Commission to consider one of two alternatives to the proposed amendment:

- First, the Commission should consider incorporating a sufficient phase-in period (*e.g.*, 35 business days) in order to allow a reasonable period of time to close-out grandfathered fails, and avoid significant disruptions in the market for these securities. Such 35-business day phase-in period

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5 Proposing Release, 71 FR at 41711.

6 As the Commission may be aware, various web sites have already been established to allow market participants to identify and take advantage of an expected price increase due to buy-ins mandated under Reg SHO. *See, e.g.*, www.buyins.net

7 *Division of Market Regulation: Key Points about Regulation SHO* (April 11, 2005). "Failures to deliver may result from either a short or a long sale. There may be legitimate reasons for a failure to deliver. For example, human or mechanical errors or processing delays can result from transferring securities in physical certificate rather than book-entry form, thus causing a failure to deliver on a long sale within the normal three-day settlement period. A fail may also result from naked short selling. For example, market makers who sell short thinly traded, illiquid stock in response to customer demand may encounter difficulty in obtaining securities when the time for delivery arrives. Naked short selling is not necessarily a violation of the federal securities laws or the Commission's rules. Indeed, in certain circumstances, naked short selling contributes to market liquidity. For example, broker-dealers that make a market in a security generally stand ready to buy and sell the security on a regular and continuous basis at a publicly quoted price, even when there are no other buyers or sellers."

8 *See, e.g.*, the SIA's request that the Commission extend the exception from the Reg SHO "locate" requirement for sales of "owned" securities, as set forth in current Rule 203(b)(2)(ii), to also except any such sales from the close-out requirement of Rule 203(b)(3), thereby allowing the seller 35 days to make delivery on such sales of "owned" threshold securities, rather than requiring buy-in after 13 settlement days. *See, infra*, Section IV.A.

should apply to every situation where a security becomes a threshold security, rather than allowing such phase-in period only for the initial close-out of fail positions in pre-existing threshold securities.

- Second, or as an alternative to the first, if the Commission does not support a separate time period for fails-to-deliver established prior to and after a stock becomes a threshold security, SIA believes that the Commission should amend the Rule 203(b)(3) close-out requirement to require clearing firm participants to take action if a fail-to-deliver remains for 20 consecutive settlement days (without a Grandfather exception), rather than the current 13 day period. Providing this additional time will allow firms to take action to close-out the potentially larger fail-to-deliver positions that will result from the removal of the Grandfather provision, in a manner that SIA believes will not cause undue disruptions in the market.

Furthermore, SIA requests that the Commission provide interpretive guidance with respect to firms' calculations of the Grandfather position that would be required to be closed-out,[9] and other issues related to such close-out. In particular, with respect to both the previously-grandfathered fail-to-deliver positions, and (after the effective date of the amendment) any fails that occurred prior to the security becoming a threshold security, firms should be permitted to designate buy-ins which are intended to close-out such grandfathered position. In such manner, firms should *not* be required to aggregate such pre-existing fails with fail-to-deliver positions established after the stock becomes a threshold security, and allocate buy-ins under the methodology prescribed in Q&A 5.8 of the Division of Market Regulation's *Frequently Asked Questions Concerning Regulation SHO*.

C. Proposal to Reference the NYA for the Index Arbitrage Exception

SIA supports the Commission's proposal to update the index arbitrage exception, embodied in Rule 200(e) of Reg SHO, to reference the NYSE Composite Index ("NYA"), instead of the Dow Jones Industrial Average ("DJIA"), for purposes of the market decline limitation in Rule 200(e)(3).[10] SIA notes that the proposal is intended to make the exception for unwinding index arbitrage positions in Rule 200(e) consistent with the provisions of NYSE Rule 80A. In this regard, SIA would urge the Commission to amend Rule 200(e)(3) in other ways to

9 Specifically, with respect to any previously-grandfathered fail-to-deliver position that is on the threshold security list on the effective date of the amendment, consistent with the operation of current Rule 203(b)(3)(i), if such position has been reduced over the course of time the security has remained on the threshold security list, firms should only be required to close-out, within the 35 settlement day period proposed, such reduced amount. For example, if a firm's original Grandfather position was 10,000 shares, however, prior to the effective date of the proposed amendment, such Grandfather position has been reduced to 1,000 shares, the firm should only be required to close-out, within 35 settlement days, such 1,000 share position. To the extent that the firm's Grandfather position has been eliminated prior to the effective date of the proposed amendment, the firm would have no obligation to buy-in, apart from buy-ins otherwise required under current Rule 203(b)(3). Should the Commission adopt SIA's suggestion to allow firms a 35-day phase-in period to close-out grandfathered fails for every situation where a security becomes a threshold security, SIA requests that the above interpretation apply to each such situation.

10 Proposing Release, 71 FR at 41716.

make it completely consistent with Rule 80A. Notably, in a manner identical to Rule 80A, the market decline limitation of Rule 200(e) should only remain in effect "for the remainder of the trading day," as opposed to the current requirement in Rule 200(e)(3) that the market decline restriction terminate "upon the establishment of the closing value of the [DJIA] on the next succeeding trading day."

IV. Questions in the Proposing Release Supported by SIA

A. Exception from Close-out Requirement for Fails in "Owned" Securities

The Proposing Release included a question on whether to extend the current close-out requirement of 13 consecutive settlement days (*e.g.*, to 35 settlement days) for fails in threshold securities that are related to sales effected pursuant to Rule 144, or other similar situations where delays may occur through no fault of the seller.[11] SIA firms agree that the current requirement in Reg SHO to close-out *all* fails in threshold securities that remain for 13 consecutive settlement days, including fails resulting from sales of securities which the seller owns, has imposed serious unintended consequences on clearing firms and the broker-dealer and non-broker-dealer customers for which they clear. For example, firms have discovered in numerous instances that their CNS fail positions in threshold securities are attributable to situations where sales are effected pursuant to Rule 144; however, due to delays in getting the restricted legend removed from the certificates (or other such delays outside the seller's control), such shares are not available for a period of time after settlement date.

This situation has been exacerbated by 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. In many situations, firms have observed that customer(s) who effect 144 sales over the course of several days will actually have clean shares available for delivery.[12] Nevertheless, under the methodology prescribed in Q&A 5.8, any such 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. These are not abusive or manipulative situations – because the seller has an ownership position in the security being sold, there is no incentive to depress the price of the security. Nevertheless, due to the nature of 144 sales, these buy-ins may generally be for

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[11] Proposing Release, 71 FR at 41713. The SEC had specifically stated as follows: "We understand that deliveries on sales of Rule 144 restricted securities are sometimes delayed through no fault of the seller (*e.g.*, to process removal of the restrictive legend). Should the current close-out requirement of 13 consecutive settlement days for Rule 144 restricted threshold securities be extended, e.g., to 35 settlement days? Please identify specific delivery problems related to Rule 144 restricted securities. Should the current close-out requirement of 13 consecutive settlement days be similarly extended for any other type of securities and, if so, why?"

[12] Due to the practice in the 144 market, sales by customers of restricted stock need to be separately tracked for delivery and receipt of shares (*e.g.*, shares need to be tracked by the broker-dealer for possession and control purposes). As such, there should be an audit trail to support the broker-dealer's allocation of the receipt of the clean shares and corresponding delivery to the appropriate account.

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.

In the interest of uniformity and ease of interpretation, and in order to provide relief for all such situations where a participant's fail positions are related to circumstances outside the seller's control, and not due to any abusive activity, SIA urges the Commission to simply extend the exception from the Reg SHO "locate" requirement for sales of "owned" securities, as set forth in current Rule 203(b)(2)(ii), to also except any such sales from the close-out requirement of Rule 203(b)(3).[13] This would therefore allow the seller 35 days to make delivery on such sales of "owned" threshold securities, rather than requiring buy-in after 13 settlement days. SIA believes that the 35 day period should permit the orderly settlement of such sales without the risk of market disruptions due to unnecessary buy-in activity.

B. Allowing Firms Increased Ability to Make Delivery on Fails by Borrowing

In response to the Commission's question, SIA believes firms should be allowed greater flexibility to make delivery on fails-to-deliver in threshold securities by borrowing securities, even where such borrowing may occur on the 13th consecutive settlement day.[14] Borrowing securities actually furthers one of the stated purposes of Reg SHO (*i.e.*, reducing fails) in a manner preferable to effecting a buy-in. In contrast to the situation where the counterparty to a buy-in may in fact fail-to-deliver the security sold (*e.g.*, where such sale is being effected in reliance on the bona-fide market maker exception from the locate requirement), the borrower will be able to actually obtain the securities from the lender and deliver to close-out its open fail positions. Moreover, borrowing securities does not impact the market in the same manner as buy-ins, which raise the potential of bidding the market price up by giving the false impression of buy-side interest in the particular threshold security or otherwise initiating a short squeeze.[15] Broker-dealers should be provided the ability to determine, between borrowing or effecting a buy-in, the most effective means of closing out their fail-to-deliver positions. SIA further requests that, for purposes of the Rule 203(b)(3) close-out requirement and all related interpretations in the Division's *Frequently Asked Questions Concerning Regulation SHO*, broker-dealers should be entitled to treat borrows in a manner consistent with buy-ins.

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13 Rule 203(b)(2)(ii) specifically provides an exception from the locate requirement for "Any sale of a security that a person is deemed to own pursuant to §242.200, provided that the broker or dealer has been reasonably informed that the person intends to deliver such security as soon as all restrictions on delivery have been removed. If the person has not delivered such security within 35 days after the trade date, the broker-dealer that effected the sale must borrow securities or close out the short position by purchasing securities of like kind and quantity."

14 Proposing Release, 71 FR at 41714. The Commission specifically stated as follows: "Would borrowing, rather than purchasing, securities to close out a position be more effective in reducing fails to deliver, or could borrowing result in prolonging fails to deliver?"

15 As noted *infra*, n. 6, the Commission may be aware of the fact that various web sites have already been established to allow market participants to identify and take advantage of an expected price increase due to buy-in activity.

C. Exception From the Close-out Requirement for ETFs and Structured Products.

The Proposing Release asked a question whether ETFs or other types of structured products should be excepted from the Reg SHO definition of "threshold securities," noting the concerns expressed by market participants that delivery failures in such products do not raise the same concerns as fails in securities of individual issuers, and that there may be unique challenges associated with the clearance and settlement of such products.[16] In response, SIA believes that the Commission should indeed provide an exception from the definition of threshold security for ETFs, as well as structured products, and closed-end funds. Evidence reveals that a sizeable percentage of threshold securities (especially those from the NYSE and AMEX) consist of such products.[17] SIA believes that these significant percentages may be related to the fact that the calculation of threshold securities does not readily translate to these products, specifically because such calculation presupposes a fixed amount of total shares outstanding (*i.e.*, the aggregate fail-to-deliver must be at least 10,000 shares and equal to at least 0.5% of the total shares outstanding). Unlike issuers of common stock, ETFs do not have such a fixed number of total shares outstanding. Although a fixed amount of ETFs may be delivered by a broker-dealer to a depository for creation, additional ETFs will be created by other market participants on an ongoing basis. Reg SHO's formula does not appropriately take into account this characteristic of ETFs and the appearance of ETFs on the threshold security lists also does not reflect a level of fails that are indicative of chronic delivery problems.

Furthermore, from a policy perspective, ETFs do not necessarily present the same concerns with respect to potential manipulative short selling activities, given the fact that the value of ETFs is derived from the market prices of the underlying basket. In this regard, we believe it notable that the definition of threshold securities does not cover other derivative securities, such as options, and the Commission has expressly noted, in granting relief from the "tick" test (as well as certain other rules) for many ETFs and structured products, that the derivative nature of these products do not lend themselves to abuse.[18] Moreover, to the extent

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16 Proposing Release, 71 FR at 41713. The Commission specifically stated as follows: "Some market participants have suggested that delivery failures in certain structured products, such as exchange traded funds (ETFs) do not raise the same concerns as fails in securities of individual issuers. We also understand that there may be particular difficulties in complying with the close-out requirements because of the structure of these products. Are there unique challenges associated with the clearance and settlement of ETFs? If so, what are these unique challenges? Should ETFs or other types of structured products be excepted from being considered threshold securities? If so, what reasons support excepting these securities?"

17 For example, for the date of August 30, 2006, out of a total of 38 threshold securities published by the NYSE, it is believed that at least 15 of such securities (approximately 40%) consisted of ETFs, structured products, or closed-end funds. http://www.nyse.com/RegulationFrameset.html?displayPage=http://www.nyse.com/threshold/home.html. With respect to the Amex, for the same date, it is believed that at least 31 out of a total of 42 threshold securities (approximately 74%) consisted of ETFs, structured products or closed-end funds. http://www.amex.com/amextrader/

18 *See*, *e.g.*, Letter re: PowerShares Lux Nanotech Portfolio (October 25, 2005). In granting relief from Rule 10a-1, the Commission Staff stated "On the basis of your representations and the facts presented, in particular the composite and derivative nature of the Shares, it would not appear that trading in the Shares would be susceptible to

short sales may cause disparities between the price of an ETF and the price of the underlying basket, this creates arbitrage opportunities, which should result in the price discrepancy being eliminated (*e.g.*, any short sales and fails of sufficient size to suppress the price of the ETF relative to the basket should result in buying interest since one could buy the ETF and convert it into the basket and sell the stock). SIA firms are unaware of any abusive or manipulative activity which has been linked to fails in ETFs. Furthermore, to the extent there are fails in ETFs, new ETFs can always be created in order to make delivery on an open fail situation. Based on the above factors, it is not believed that excluding ETFs, structured products, and closed-end funds from the definition of threshold securities will constitute a controversial amendment.

D. Public Disclosure of Fail Positions in Threshold Securities

The Proposing Release included a question on whether the Commission 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.[19] In response, SIA would not be opposed to the SROs disclosing, on an aggregate basis, fails in individual threshold securities. It is SIA's understanding that the Commission already receives from NSCC aggregate fail-to-deliver information on individual securities, and provides it to the SROs for the purpose of calculating the threshold security lists. As such, there would be no need for the Commission to amend Reg SHO so as to require broker-dealers to disclose such information.

SIA urges the Commission to consider, however, the potentially misleading nature of such information. As the Commission has noted, not all fails indicate activity that is abusive or even violates federal securities laws.[20] However, even such non-abusive fails could cause a security to become included on the threshold security list, albeit perhaps for a short period of time. For example, a stock may become included on the threshold security list due to fails-to-deliver resulting from an officer or director of an issuer selling formerly-restricted

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the practices that Rule 10a-1 is designed to prevent. In particular, the Trust anticipates that the market value of the Shares will rise or fall based on changes in the net asset value of the Component Stocks of the Index and supply and demand. Moreover, the short sale rule does not apply to analogous derivative products such as index options and index futures contracts. Accordingly, the Commission hereby grants an exemption from Rule 10a-1 to permit sales of the Shares without regard to the 'tick' requirements of Rule 10a-1."

19 Proposing Release, 71 FR at 41714. "Some people have asked for disclosure of aggregate fail-to-deliver positions to provide greater transparency. Should we require the amount or level of fails to deliver in threshold securities to be publicly disclosed? Would requiring information about the amount of fails to deliver help reduce the number of persistent fails to deliver? Should such disclosure be done on an aggregate or individual stock basis? If so, who should make this disclosure (e.g., should each broker be required to disclose the aggregate fails to deliver amount for each threshold security or, alternatively, should the SROs be required to post this information)? How should this information be disseminated? In what way would providing the investing public with access to aggregate fails data be useful? Would providing the investing public with access to this information on an individual stock basis increase the potential for manipulative short squeezes? If not, why not? How frequently should this information be disseminated? Should it be disseminated on a delayed basis to reduce the potential for manipulative short squeezes? If so, how much of a delay would be appropriate?"

20 *See, supra*. n. 7.

company shares, or due to other sales related to syndicate activity. Disclosing the amount of fails in such "temporary" threshold securities could cause market participants to erroneously believe that the particular issuer is experiencing problems, or that other market participants may be taking short positions based on a negative view of the company. Contrary to the policy reasons underlying Reg SHO, such misleading information could actually encourage increased short selling in the company's stock.

To help remedy any such misperceptions, and guard against the potential unintended consequences to issuers, SIA believes that disclosure of aggregate fails information should only cover any security which has remained on the threshold security list for 30 consecutive settlement days. This would help ensure that aggregate fail information would only be disclosed for those threshold securities which have extended settlement failures, and would not cover the situation where a security may appear on the threshold security list for a temporary period of time, perhaps due to the aberrant situations noted above. SIA believes that the proposed 30-day timeframe would be consistent with the relief that the SEC has provided from the close-out requirement for syndicate activity in Q&A 1.5 of the Division's *Frequently Asked Questions Concerning Regulation SHO.*[21] In order to guard against other negative effects that could result from the disclosure of fail information, SIA believes that the Commission should only require SROs to provide such aggregate fail information on a delayed basis (*e.g.*, a 30-day look-back).

While SIA does not oppose the disclosure of aggregate fail to deliver information, pursuant to the conditions noted above, SIA strongly urges the Commission to not require broker-dealers to publicly identify their individual fail-to-deliver positions. Requiring the identification and release of such information would force broker-dealers to devote considerable resources to unraveling complex processing streams that, in the end, would yield little useful information. Furthermore, disclosing such proprietary data could harm customers (and broker-dealers) by exposing them to potential short squeezes.[22]

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[21] "**Question 1.5:** Do the requirements of Rule 203 of Regulation SHO apply to short sales made in connection with underwritten offerings?

Answer: Syndicate activity is not expressly addressed in Regulation SHO. However, the Staff will not recommend enforcement action for violation of Rule 203(b)(1) of Regulation SHO (locate requirement) with regard to any sale by an underwriter, or any member of a syndicate or group participating in the distribution of a security, in connection with an over-allotment of securities, or any lay-off sale by such a person in connection with a distribution of securities through rights or a standby underwriting commitment. <u>In addition, the Staff will not recommend enforcement action for violation of Rule 203(b)(3) of Regulation SHO (close-out and pre-borrow requirements) with respect to a net syndicate short position created in connection with a distribution of a security that is part of a fail to deliver position at a registered clearing agency in a threshold security that has persisted for 13 consecutive settlement days, if action is taken to close out the net syndicate short position no later than the 30th day after commencement of sales in the distribution.</u>" (emphasis added)

[22] The Commission has recognized in other areas the importance of maintaining confidentiality over proprietary customer information, such as through Regulation S-P, which was enacted as part of the Gramm-Leach-Bliley Act.

IV. Questions in the Proposing Release Opposed by SIA

A. Question on Only Allowing Use of Lenders Decrementing Available Borrow

The Commission included a question in the Proposing Release on whether to require broker-dealers, in determining compliance with the locate requirement, to only rely on lenders that decrement their available borrow.[23] SIA strongly opposes the imposition of any such requirement, as it would fundamentally alter the manner in which firms currently rely on inventory feeds from lenders, and would therefore have a severe impact on overall stock lending operations. In a similar manner, SIA notes that a number of commenters to the Proposing Release have recommended amending Reg SHO to require short sellers, prior to sale, to actually borrow securities, rather than the current requirement to have "reasonable grounds" to believe the security can be borrowed (*i.e.*, obtain a "locate").

SIA believes it is important to note that a "locate" is not equivalent to a borrow. Indeed, many locates do not even result in actual borrowing on settlement date, due to, among other reasons, the fact that the potential seller ultimately decides not to effect the short sale transaction, or the securities have otherwise been bought back to cover the short sale. Estimates from SIA member firms of the number of locate requests that result in actual short sales are generally in the range of 10% or less. Therefore, requiring a potential short seller to actually borrow securities prior to sale, and/or requiring a lender to decrement the amount of stock for which it provides availability to broker-dealers (*e.g.*, requiring a lender who has 1,000,000 shares of a security available to lend to apportion 100,000 shares to 10 different broker-dealers) will severely hamper the liquidity of the stock lending market, as well as require major systems changes to incorporate such information. Moreover, it is important to note that lenders have no way of knowing when their available supply has been used by a broker-dealer to support a locate, and, as such, the lenders have no basis for decrementation. Once the securities have been borrowed, lenders should be able to adjust the availability feeds they provide for the subsequent day to account for any such borrowing. In the end, SIA firms are not aware of, and the Commission has not cited in the Proposing Release, any evidence demonstrating that the activity sought to be addressed has resulted in increased fails in the marketplace, or has otherwise facilitated abusive or manipulative activity.

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[23] Proposing Release, 71 FR at 41714. The Commission specifically stated as follows: "Rule 203(b)(1)'s current locate requirement generally prohibits brokers from using the same shares located from the same source for multiple short sales. However, Rule 203(b)(1) does not similarly restrict the sources that provide the locates. We understand that some sources may be providing multiple locates using the same shares to multiple broker-dealers. Thus, should we amend Rule 203(b)(1) to provide for stricter locates? For example, should we require that brokers obtain locates only from sources that agree to, and that the broker reasonably believes will, decrement shares (so that the source may not provide a locate of the same shares to multiple parties)? Would doing so reduce the potential for fails to deliver? Should we consider other amendments to the locate requirement? Would requiring stricter locate requirements reduce liquidity? If so, would the reduction in liquidity affect some types of securities more than others (e.g., hard to borrow securities or securities issued by smaller companies)? Should stricter locate requirements be implemented only for securities that are hard to borrow (*e.g.*, threshold securities)?"

B. Question on Whether to *Require* Tracking of Fails by Account

The Proposing Release included a question on whether the Commission should amend Reg SHO to require firms to track and close-out fails to deliver at the individual account level, as opposed to the current requirement for clearing firm participants to track and close-out fail-to-deliver positions at the CNS level.[24] SIA believes that the Commission correctly decided not to previously incorporate into Reg SHO a requirement for participants to identify specific accounts causing fails in threshold securities, and take specific action against such accounts (*i.e.*, freezing for 90 calendar days). In particular, in adopting Reg SHO, the Commission recognized the statements of commenters, including NSCC, that "under the confines of current settlement practices and procedures, it is not practical to assign delivery failures to a particular clearing firm customer account…because NSCC's continuous net settlement ('CNS') system nets all buys and sells in each security for each NSCC participant, broker-dealers cannot determine which customer's transaction or account gave rise to a failure to deliver."[25] This remains the case today.

SIA acknowledges the Commission's statements in the Reg SHO Adopting Release that, "if the Commission believes that the rules as adopted are not having the intended effects of reducing potentially manipulative behavior, we may consider additional rulemaking that could require broker-dealers to identify individual accounts that are causing fails to deliver."[26] This being the case, however, the aforementioned data cited by the Commission in the Proposing Release (and attached as Appendix A) demonstrates that the Rule as currently drafted *is* having its intended effects. In light of this, requiring wholesale changes to the national clearance and settlement system which could significantly and adversely affect that system's efficient operation is neither warranted nor appropriate.

SIA therefore supports continuing the current framework of permitting (rather than requiring) firms to reasonably allocate fail positions to broker-dealers for which they clear (under Rule 203(b)(3)(iv)),[27] and would support extending the provisions of 203(b)(3)(iv) to

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[24] Proposing Release, 71 FR at 41713. The Commission specifically stated the following: "When Regulation SHO was proposed, commenters noted difficulties tracking individual accounts in determining fails to deliver. However, we understand that some firms now track internally the accounts responsible for fails. Should we consider requiring customer account-level close out? Should firms be required to prohibit all short sales in that security by an account if that account becomes subject to close out in that security, rather than requiring that account to pre-borrow before effecting any further short sales in the particular threshold security?"

[25] Securities Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008, 48017 (August 6, 2004) ("Reg SHO Adopting Release").

[26] *Id.*

[27] The Commission had stated as follows in the Reg SHO Adopting Release concerning this provision: "Rule 203(b)(3)(iv) also provides that a participant may reasonably allocate its responsibility to close out open fail positions in threshold securities to another broker-dealer for which the participant is responsible for settlement. Thus, participants that are able to identify the accounts of broker-dealers for which they clear may allocate the responsibility to close out open fail-to-deliver positions to the particular account(s) whose trading activities have caused the fail-to-deliver position. Absent such identification, however, the participant would remain subject to the close out requirement." Reg SHO Adopting Release, 69 FR at 48018.

allow (but not require) such reasonable allocation of fail positions to accounts of customers who may not be registered broker-dealers.[28]

C. Question on Requiring Broker-dealers to Annotate Information re: "long" Sales

The Proposing Release included a question on 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.[29] SIA opposes the Commission incorporating these requirements into the Rule. Broker-dealers have already established procedures for confirming that sales are marked properly, based on information provided by customers and a broker-dealer's own books and records. SIA does not believe that the Commission has presented evidence that the absence of a specific annotation requirement has contributed to abusive or manipulative activities.

Moreover, such an annotation requirement for long sales may raise separate issues with respect to prime brokerage activities. SIA therefore urges the Commission to forgo amending Reg SHO in this manner until the Commission and the industry have taken steps to resolve such issues, such as by amending the 1994 Prime Broker No-Action letter. Any such modifications could be designed to enhance communications between prime brokers and executing brokers with respect to order marking to ensure that the customer is providing accurate information to the executing broker.

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[28] *See, e.g.*, the SIA's request that the Commission extend the exception from the Reg SHO "locate" requirement for sales of "owned" securities, as set forth in current Rule 203(b)(2)(ii), to also except any such sales from the close-out requirement of Rule 203(b)(3), thereby allowing the seller 35 days to make delivery on such sales of "owned" threshold securities, rather than requiring buy-in after 13 settlement days. *See, supra,* Section IV.A.

[29] Proposing Release, 71 FR at 41714. The Commission stated as follows: "Current Rule 203(a) provides that on a long sale, a broker-dealer cannot fail or loan shares unless, in advance of the sale, it has demonstrated that it has ascertained that the customer owned the shares, and had been reasonably informed that the seller would deliver the security prior to settlement of the transaction. Former NASD Rule 3370 required that a broker making an affirmative determination that a customer was long must make a notation on the order ticket at the time an order was taken which reflected the conversation with the customer as to the present location of the securities, whether they were in good deliverable form, and the customer's ability to deliver them to the member within three business days. Should we consider amending Regulation SHO to include these additional documentation requirements? If so, should any modifications be made to these additional requirements? In the prior SRO rules, brokers did not have to document long sales if the securities were on deposit in good deliverable form with certain depositories, if instructions had been forwarded to the depository to deliver the securities against payment ("DVP trades"). Under Regulation SHO, a broker may not lend or arrange to lend, or fail, on any security marked long unless, among other things, the broker knows or has been reasonably informed by the seller that the seller owns the security and that the seller would deliver the security prior to settlement and failed to do so. Is it generally reasonable for a broker to believe that a DVP trade will settle on time? Should we consider including or specifically excluding an exception for DVP trades or other trades on any rule requiring documentation of long sales?"

If the Commission *does* decide that the costs of imposing such additional annotation requirements do not outweigh the benefits, SIA believes it would be necessary to include exceptions for prime brokerage and DVP trades, "done with" trades, and orders submitted electronically (*e.g.*, through direct market access systems). Specifically, a broker-dealer should be provided an exception from such long sale annotation requirements if the broker-dealer has information regarding the client's custodial relationship. Providing such an exception would be consistent with the Commission's long-standing policy of allowing broker-dealers to enter into bona-fide agreements with their customers regarding the marking of orders.[30]

VI. Conclusion

SIA respectfully urges the careful consideration of the above comments and questions regarding the proposed amendments and items raised for comment in the Proposing Release, as it believes that certain of these issues would not appear to be in the best interests of the U.S. capital markets, and would create risks and impose substantial costs upon broker-dealers that would not be commensurate with the benefits that might be received. If you have any questions, please contact the undersigned at (202) 216-2000 or Amal Aly, SIA Vice President and Associate General Counsel, at (212) 608-1500.

Sincerely,

Ira D. Hammerman

Ira D. Hammerman
SIA Senior Vice President and
General Counsel

cc: The Hon. Christopher Cox, Chairman
The Hon. Paul Atkins, Commissioner
The Hon. Roel Campos, Commissioner
The Hon. Annette Nazareth, Commissioner
The Hon. Kathleen Casey, Commissioner

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[30] The use of contractual agreements with customers regarding the marking of orders has existed ever since short sale regulations were initially enacted in the 1930's. In particular, in 1938 the SEC confirmed a New York Stock Exchange interpretation that endorsed the use of contractual agreements, "[t]o obviate the necessity of hurriedly obtaining the information specified in rule [10A-2], it is advisable for the member when he receives the order also to obtain information from the seller as to the practicability of then delivering the security. As a method of obtaining such information with respect to an order to sell, a member (including any floor broker) may enter into any bona-fide written agreement with his customer that the customer, when placing 'short' sell orders, will designate them as such, and that the designation of a sell order as 'long' is a representation by the customer to the member that the customer owns the security, that it is then impracticable to deliver the security to such member and that the customer will deliver it as soon as is possible without undue inconvenience or expense." (emphasis added) Securities Exchange Act Release No. 1571 (February 5, 1938).

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Appendix A – Pertinent Data on Fails from Reg SHO Proposing Release and OEA Memo

- According to data received from the National Securities Clearing Corporation ("NSCC"), on an average day, approximately 1% (by dollar value) of all trades, including equity, debt, and municipal securities, fail to settle. In other words, 99% (by dollar value) of all trades settle on time, and the vast majority of fails are closed out within five days after T+3.
- The average daily aggregate fails to deliver declined by 34.0% after the effective date of Regulation SHO.
- The average daily number of threshold securities declined by 38.2% from the pre- to post-rule periods.
- The average daily fails of threshold securities declined by 52.4%.
- The average daily number of threshold securities declined by 29.8% from January 2005 to May 2006.
- For exchange-listed issues, the average daily number of threshold securities during May 2006 was about 2.18% of all issues.
- For all issues traded in the U.S. (including OTCBB and Pink Sheets), the average daily number of threshold securities during May 2006 was about 0.38% of all issues.
- A total of 6,223 securities "graduated" from the threshold list since January 10, 2005, representing 4.5 billion shares in initial fails.
- Only 6 securities have "persisted" on the threshold list since January 10, 2005, and even these 6 securities have seen their fails drop by 68.6%.
- 99.2% of the fails that existed on January 3, 2005 are no longer outstanding as of March 31, 2006.