Knight

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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
<u>Proposed Amendments to Regulation SHO</u>

Dear Ms. Morris:

Knight Capital Group, Inc. ("Knight")[1] welcomes the opportunity to offer our comments to the Securities and Exchange Commission ("Commission") on the proposed amendments to Regulation SHO.[2] The proposed amendments seek to: (i) eliminate the grandfather provision for fails; (ii) modify the options market maker exemption for closing out fails; and (iii) address the unwinding index arbitrage positions. The Commission also requests comment on a number of additional questions. Since our business will be impacted directly by the proposal relating to the elimination of the grandfather provision, we will focus most of our comments on that issue.

<u>Proposed elimination of the grandfather provision</u>

The Commission proposes to eliminate the grandfather clause of Rule 203(b)(3)(i). This rule generally exempts fails to deliver that existed prior to the security becoming a threshold security. The new amendment would require that all grandfathered fails be closed-out within 35 settlement days from the effective date of the amendment and if a security becomes a threshold security after the effective date, all fails would need to be closed out within 13 consecutive settlement days. We respectfully oppose such a change.

[1] Knight is the parent company of Knight Equity Markets, L.P., Knight Capital Markets LLC, Direct Edge ECN LLC, Knight Equity Markets International Ltd., Direct Trading Institutional, L.P., and Hotspot FXR, LLC all of whom are registered with SEC or CFTC. Knight through its affiliates make markets in equity securities listed on Nasdaq, OTC Bulletin Board, New York Stock Exchange, and American Stock Exchange, both in the United States and Europe. Knight also owns an asset management business for institutional investors and high net worth individuals through its Deephaven subsidiary. Knight is a major liquidity center for the Nasdaq and listed markets. We trade nearly all equity securities. On active days, Knight executes in excess of one million trades, with volume exceeding one billion shares. Knight's clients include more than 600 broker-dealers and 1000 institutional clients. Currently, Knight employs more than 800 people.

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

We believe that the empirical data now available shows that this proposal is not necessary – see, Memorandum from the Commission's Office of Economic Analysis (August 21, 2006). For example, "99.2% of the fails that existed on January 3, 2005 are no longer outstanding as of March 31, 2006" (Memorandum at page 2).

Additionally, the elimination of the grandfather provision will lead to increased volatility in these securities, created by short squeezes as individuals attempt to cover positions. Importantly, the elimination of the grandfather provision will negatively impact *bona fide* market making and the ability of market makers to provide liquidity. As the Division of Market Regulation correctly noted,

> There may be legitimate reasons for a failure to deliver....For example, <u>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</u>.
>
> Naked short selling is not necessarily a violation of the federal securities laws or the Commission's rules. Indeed, in certain circumstances, <u>naked short selling contributes to market liquidity</u>. 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. Thus, <u>market makers must sell a security to a buyer even when there are temporary shortages of that security available in the market</u>. This may occur, for example, if there is a sudden surge in buying interest in that security, or if few investors are selling the security at that time. Because it may take a market maker considerable time to purchase or arrange to borrow the security, a market maker engaged in bona fide market making, particularly in a fast-moving market, may need to sell the security short without having arranged to borrow shares. <u>This is especially true for market makers in thinly traded, illiquid stocks such as securities quoted on the OTC Bulletin Board, as there may be few shares available to purchase or borrow at a given time</u>. (emphasis supplied and citations omitted)
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> <u>See</u>, Division of Market Regulation: Key Points About Regulation SHO (April 11, 2005).

Thus, to restrict – indeed eliminate, the ability of market makers to satisfy these investor needs will undoubtedly lead to less liquidity, greater volatility, and widening of spreads. Further, in certain instances, restricting *bona fide* market making in such a fashion could lead to upward price manipulation (i.e., the return of "pump & dump" schemes) causing investors to purchase shares at inflated prices.

If the Commission does determine, however, to move forward with the elimination of the grandfather clause, we urge the Commission to adopt a *permanent* phase-in period of 35 days for all fails to deliver incurred in securities prior to those securities becoming a threshold security. In addition to the reasons stated above, Knight is very concerned that the elimination of the grandfather provision will necessarily inject a new risk dynamic into the market making process that is nearly impossible to predict and even more difficult to measure. More specifically, when making a decision whether to sell short to an investor seeking to buy a "non-threshold" stock, a market maker today can adequately assess the risk associated with providing liquidity and capital to that order. Although there is always a risk of price movement, a market maker can manage that risk by deciding when to buy back that position. Under the current proposal, the market maker loses that risk management capability. Thus, if the stock is not a threshold security the day the market maker sells short to an investor, but becomes a threshold security shortly thereafter, the risk incurred by the market maker on the day it went short will exponentially increase – since, the market maker can no longer manage its exit point on the position and will now be forced to close that position within 13 consecutive settlement days. In effect, a new and substantial risk will be applied *retroactively* to a market making decision made in the past. So, through no fault of its own, the market maker is now forced into a potentially precarious – and costly, position.

Consequently, in light of the additional and substantial new risks the market maker is being asked to bear, and since this risk will be incurred in connection with activities designed to serve the investing public (i.e., *bona fide* market making), we suggest an extended, permanent buy-in period of 35 settlement days in these situations. No harm will come to any investor or the marketplace with this modest extension of time, however it will help market makers somewhat manage this newly created risk.

<u>Additional questions posed by the Commission</u>

The Commission raised additional questions in the proposed amendments which we would also like to address:

1. *Should there be, "a mandatory pre-borrow requirement in lieu of a locate requirement for threshold securities with extended fails?"*

   If the Commission was to adopt a mandatory pre-borrow requirement in lieu of a locate requirement for threshold securities with extended fails to deliver, we submit that the Commission should clarify that such requirement would not be imposed on transactions that are exempted from Rule 203(b)(1) by Rule 203(b)(2). If such transactions are not exempted from the pre-borrow requirement, it could impact a market maker even if it did not have an extended fail. Such a requirement could also provide an un-level playing field to certain market participants. Specifically, broker/dealers that have extensive stock loan businesses will have the advantage of transacting in securities at costs much lower than other firms. Overall costs to other broker/dealers would increase as they would have to use capital and pay higher borrow costs to make a market in the stock even though they are not contributing to the fail. In addition, a market maker would be required to incur these borrow costs if it wanted to post quotations if such quotations may result in the market maker selling stock short. This will impact negatively a market maker's ability to make markets in threshold securities – thereby reducing liquidity for threshold securities.

2. *Should the, "current close-out requirement of 13 consecutive settlement days for Rule 144 restricted threshold securities or other types of threshold securities should be extended?"*

Knight supports extending the close-out requirement from 13 consecutive settlement days to at least 35 settlement days for sales in threshold securities related to sales effected pursuant to SEC Rule 144, or other similar situations where delays may occur in settlement. Requiring a close-out of "owned" shares in the 13-day period has resulted in serious consequences to sellers that "own" a security who, through no fault of the seller, were not able to settle the transaction by the 13th day. For example, the mechanics of having the transfer agent remove a restrictive legend often results in delays of settling transaction beyond 13 settlement days.[3] These delays are not a result of the abusive short selling practices that Regulation SHO was intended to address. Instead, they are typically a result of ensuring that proper documentation is received to remove the legend (e.g., an opinion of counsel).

In addition, transactions in restricted securities are typically larger in size and occur over several days or weeks which increases the risk that such transactions will be subject to a buy-in because: (i) the fails associated with the sales of restricted shares may be sufficient enough to cause the security to become a threshold security or delay a security from being removed from the threshold list;[4] and (ii) sellers are typically not permitted to start the process of removing the restrictive legend until after the shares are sold. Moreover, using the last-in-first-out ("LIFO") method of closing out fails-to-deliver, the seller of restricted securities is subject to a greater risk of buy-in because shares that are delivered to settle one trade may be applied to a subsequent trade that is also causing a fail-to-deliver.[5]

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[3] The Commission has previously recognized these delays when it adopted Rule 203(b)(2) which provides an exception from the locate requirement for "[a]ny 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."

[4] In general, a security is a threshold security if it has aggregate fails to deliver at a registered clearing agency for five consecutive settlement days and such fails are 10,000 shares (or more) and equal to at least 0.5% of its outstanding shares. Restricted stock transactions are often for an amount of shares greater than 0.5% of the outstanding shares of a security. For example, Rule 144 permits sales of *at least* 1% of the outstanding shares of a class of securities in any three-month period, and resale registration statements are typically filed for an amount of shares that are greater than 0.5% of the outstanding shares of a security.

[5] For example, assuming that a client sold 5,000 shares of restricted securities with a settlement date of 9/4/06 and 6,000 shares of restricted securities with a settlement date of 9/14/06, and each restricted sale

3. *Should the Commission except "ETFs or other types of structured products from the definition of threshold securities?"*

   We support such a proposal and submit that such an exception should extend to other structured products and American Depository Receipts (ADRs). These types of securities are not subject to the potential short selling abuses as there value is derived from an underlying basket of securities or underlying foreign security. In addition, ETFs and ADRs are in continuous distributions making it difficult to determine the correct outstanding shares for such securities. Thus, the securities may become threshold securities when the fails-to-deliver do not amount to 0.5% of the true outstanding shares.

4. *Should the Commission, "consider tightening the locate requirements?"*

   The Commission asks whether it should require that brokers/dealers obtain locates only from sources that will decrement shares. We respectfully oppose this proposal, as it will negatively impact the ability of a broker/dealer to borrow stock. Since the vast majority of locates do not result in an actual borrow by settlement, requiring a decrement base simply on a locate request would have the effect of reducing substantially the available stock for lending – thus, increasing the cost to borrow the shares and overall clearing costs (which, ultimately, may be passed on to the investor). Further, we also believe that a great deal of time and money will need to be spent by the clearing industry in developing systems and procedures designed to accurately count and decrement shares each time a locate is requested, cancelled, etc. In our view, the stock lending market is not based on the ability to deliver all shares for which there is a locate requested – rather, it is based on the ability to deliver stock in those instances where a broker/dealer is required to borrow the stock to settle a short sale. Since most locates do not result in a need to borrow shares to settle trades, there is no compelling reason to tie-up all stock available for lending.

5. *Should the Commission require the, "dissemination of aggregate fails data or fails data by individual security?"*

   We respectfully disagree with this proposal. Such disclosure would cause more confusion as the information is not indicative of abusive short selling, especially in light of fails caused by "owned" securities (restricted sales). Thus, for example, investors may mistakenly believe that a large percentage of fails to deliver is indicative of abusive short selling or problems with the issuer, when it could be a

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resulted in the only fails to deliver for the clearing participant (who was failing to deliver the total 11,000 shares). If the client then delivered 5,000 shares on 9/15/06, the clearing firm would apply those 5,000 shares to the trade that settled on 9/14/06 and no shares to the trade that settled on 9/4/06. Accordingly, even though the client delivered in shares to settle the first trade, the 5,000 shares of that trade would continue to age based on a settlement date of 9/4/06 and be subject to buy-in on 9/20/06.

result of an operational delay with a transfer agent or a delay in removing the legend for a restricted securities transaction. This mistaken belief could result in increased volatility in the stock and increased short selling.

If the Commission were to require aggregate fail data to be published, Knight believes that such information should be limited to aggregate street-wide fails by cusip number, and that SROs should publish the data they receive from the National Securities Clearing Corporation ("NSCC"). In addition, the data should only be published for securities that are on the threshold list for 35 consecutive settlement days to avoid situations where the security became a threshold security as a result of restricted securities transactions or operational delays.

6. *Should the Commission require, "additional specific documentation of long sales?"*

We would oppose such a new requirement. We are not aware of any data which suggests there is a problem in this area. Most broker/dealers have fairly extensive compliance and supervisory requirements designed to confirm sales are properly marked "long" or "short" and to monitor settlement of transactions by its clients. This new proposal will add substantial costs to an already robust infrastructure, with minimal benefit. However, if the Commission does seek to amend Regulation SHO to require increased documentation for long sales, Knight submits that an executing broker should be exempt from such requirements when there is: (i) a prime brokerage relationship; (ii) the trade is a DVP trade; (iii) settlement instructions are on file with the executing broker; or, (iv) the order is sent electronically.

Conclusion

We commend the continued efforts of the Commission to make improvements to Regulation SHO and the marketplace. Knight would welcome the opportunity to discuss our comments with the Commission.

Respectfully submitted,

Leonard J. Amoruso

cc Chairman Christopher Cox
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Annette L. Nazareth
Commissioner Kathleen Casey
Dr. Erik Sirri, Director, Division of Market Regulation
Robert L. D. Colby, Deputy Director, Division of Market Regulation
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