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AMERICAN BAR ASSOCIATION

Section of Business Law
321 North Clark Street
Chicago, Illinois 60610
(312) 988-5588
FAX: (312) 988-5578
email: businesslaw@abanet.org
website: www.abanet.org/buslaw

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Via E-mail to: rule-comments@sec.gov

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-9303
Attention: Nancy M. Morris, Secretary

Re: File No. S7-12-06 - Amendments to Regulation SHO

Ladies and Gentlemen:

This letter is submitted on behalf of the Committee on Federal Regulation of Securities (the "Committee") of the Section of Business Law of the American Bar Association (the "ABA") in response to the request of the Securities and Exchange Commission (the "Commission") for comments on proposed amendments to Regulation SHO contained in Exchange Act Release No. 54154 (the "Proposing Release").[1]

The comments expressed in this letter represent the views of the Committee only and have not been approved by the ABA's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, this letter does not represent the official position of the ABA Section of Business Law, nor does it necessarily reflect the views of all members of the Committee.

I. Introduction and General Comments

The Committee would like to thank the Commission for this opportunity to comment on the proposed changes to Regulation SHO. We commend the Commission and the Staff for your efforts in monitoring the effects of the adoption of Regulation SHO, and for your prompt action

[1] Exchange Act Release No. 54154 (July 14, 2006), 71 Fed. Reg. 41710 (July 21, 2006).

in proposing changes where you have perceived the need for change. The adoption of Regulation SHO was an important step toward the much-needed rationalization and harmonization of the regulation of short sales in the United States. Similarly, the Committee recognizes that the Commission's work will continue with the review of the data and comments relating to the Regulation SHO pilot and anticipated proposal regarding the establishment of a uniform price test or the elimination of price tests.

The Proposing Release sets forth three discrete proposals to amend Regulation SHO. The Proposing Release also asks a wide variety of questions relating to Regulation SHO, and only some of those questions are closely related to the three actual proposals. We are not responding to each of the questions posed in the Proposing Release; rather, we have tried to limit our comments primarily to issues that may be characterized more appropriately as legal issues rather than business or operational ones, preferring to let industry participants, issuers and investors comment on those practical aspects of the proposal.

Before addressing any of the specifics of the Commission's proposed changes to Regulation SHO and its further questions, we would first like to express several more general comments relating to Regulation SHO and any possible changes to it.

A. Importance of Uniformity

The Committee believes that uniformity of short sale regulation is an important goal in furtherance of the national market system. Against the background of the Commission's considerable recent and continuing efforts toward creating more uniform short sale regulation, the Committee notes the recent legislation passed by the State of Utah imposing additional obligations on broker-dealers registered in that state with respect to any failures to deliver the securities of Utah-based issuers. This legislation has prompted a lawsuit by the Securities Industry Association to halt its implementation.

Without commenting on the merits of the Utah case, efforts such as the one undertaken by Utah undermine the uniformity of short sale regulation that the Commission has been working so hard to create. Moreover, notwithstanding the legal issues, it is impractical in a national market system for regulated entities doing business in all fifty states to be required to follow different procedures for short sales depending on the state in which the issuer is located.[2] The costs of implementing state-by-state systems for short-sale rule compliance would far outweigh the benefit (if any) of allowing such micro-regulation. The Committee understands the desire of the State of Utah in this case, and states generally, to act in the best interests of their citizens; nevertheless, we believe uniformity across states and marketplaces, when dealing with relatively

[2] If the Commission permits states to regulate short sales, there is a significant potential for overlapping and inconsistent regulation. Some states could choose to regulate based on the state of incorporation of the issuer, others based on the headquarters of the issuer, or on the location of the customer or the location of the office in which the order is handled. Such a result would make state-level short sale regulation even more complex and difficult, without any corresponding investor protection benefit.

complex regulatory matters such as short sales and related borrowing and delivery obligations, is essential to the efficient functioning of the U.S. capital markets.

As a result, the Committee believes the Commission should make as clear as possible its intention to have Regulation SHO stand as the single national standard applicable to short sales and related issues such as order-marking and failures to deliver. We encourage the Commission to reach out to state regulators in the rulemaking process so that their concerns and the concerns of their constituents can be fully heard. Of course, we do not suggest that the states should or will ignore fraudulent or manipulative unscrupulous practices, whether through the use of short sales or otherwise. To the extent that short selling is part of a fraudulent or manipulative scheme, the states and the Commission can and should take decisive action against that scheme. However, the states and the Commission already have full authority under their general anti-fraud and anti-manipulation provisions to do so, and it is therefore not necessary to amend the short sale rules to prevent this type of intentional misconduct.

B. Importance of Evidentiary Support and Publication of Data

The Committee believes the Commission should adopt changes to Regulation SHO only if the Commission has substantial reason to believe such changes are necessary after providing the public with the opportunity to comment on the information considered by the Commission in making its decision. As the Commission regularly notes when discussing the regulation of short sales, short selling provides beneficial liquidity to the markets and enhances the price discovery process, so we believe the Commission should not create unnecessary regulatory obstacles to short selling. The proposed elimination of the grandfather provision and the limitation of the options market maker exception may cause adverse consequences, including decreased liquidity and increased opportunities for manipulative short-squeeze activity in connection with close-outs.

Specifically, as relates to the Commission's two primary Regulation SHO proposals, we do not believe the Commission has demonstrated the need for the proposed changes in light of the possible adverse consequences. Although the Commission notes in the Proposing Release the relative success of Regulation SHO in reducing fails to deliver and provides detailed data evidencing the reduction in fails to deliver, the Commission provides absolutely no data or other information evidencing the cause of the "small number of threshold securities with substantial and persistent fails to deliver positions," much less does it demonstrate a link between the grandfather provision or options market maker exception and the observed fails to deliver.[3].

The Proposing Release states merely that "[b]ased on these [Commission Staff and SRO] examinations and our discussions with the SROs and market participants, we believe that these persistent fail positions may be attributable primarily to the grandfather provision and, secondarily, to reliance on the options market maker exception." The Administrative Procedure

[3] The Committee agrees with the Commission that it is desirable as a policy matter to reduce further the number of securities with substantial and persistent fails.

Act ("APA") requires the Commission to discuss the results of the examinations in the Proposing Release and to provide a rationale as to why the results of those examinations led the Commission to conclude that these two provisions "**may**" be the cause of the fails. Section 553 of the APA requires that an agency such as the Commission make available for public evaluation the studies and data upon which the agency relies when proposing a rule.[4] As the United States Court of Appeals for the D.C. Circuit recently stated in *Chamber of Commerce v. SEC*, the APA requires "the 'most critical factual material' used by [an] agency be subjected to informed comment … to ensure that agency regulations are tested through exposure to public comment, to afford affected parties an opportunity to present comment and evidence to support their positions, and thereby to enhance the quality of judicial review."[5] Without the benefit of knowing the information relied upon by the Commission in analyzing the cause or causes of the current fails to deliver and the likelihood that the proposed changes will reduce those fails to deliver, commenters are deprived of the opportunity to opine on the significance of the examination results or the Commission's interpretation of such information. The Committee urges the Commission to make that data available for comment before it adopts a final rule in this rulemaking.[6]

C. Circumstances Necessitating Further Proposals or Reproposals

In addition to questions relating to the three specific proposals, the Commission also posed a number of more general questions relating to Regulation SHO. While we do not answer each of the questions posed, we believe that to the extent the responses received to these more general questions persuade the Commission that further changes to Regulation SHO are appropriate, the Commission should undertake further proposed rulemaking rather than immediately adopting additional, unproposed changes. If the Commission determines preliminarily that Regulation SHO should be changed in ways that depart significantly from the specific proposals in the Proposing Release, the public should be provided adequate notice of that determination and an opportunity to comment in response to the specific additional changes under consideration. Without notice of specific text of further proposed changes to Regulation SHO and without the opportunity to comment on any data in support of such changes, we believe it would be inappropriate and unwise for the Commission to adopt any such additional changes at this time.

D. Transitional Provisions

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[4] *See Chamber of Commerce v. SEC*, 443 F.3d 890, 899(D.C. Cir. 2006) (*citing Solite Corp. v. EPA*, 952 F.2d 473, 484 (D.C. Cir. 1991)).

[5] *Chamber of Commerce v. SEC*, 443 F.3d at 900 (*quoting Ass'n of Data Processing Serv. Orgs., Inc. v. Bd. of Governors of the Fed. Reserve Sys.*, 745 F.2d 677, 684 (D.C. Cir 1984)).

[6] The Committee notes that on August 21, 2006, the Commission made available a brief memorandum prepared by its Office of Economic Analysis entitled "Fails to Deliver Pre- and Post-Regulation SHO" (available at http://www.sec.gov/spotlight/failstodeliver082106.pdf). However, this document does not discuss the examinations referenced in the Proposing Release nor does it contain any data relating the substantial and persistent fails to deliver observed by the Commission with either the grandfather provision or options market maker exception.

With respect to both the proposed elimination of the grandfather provision and the limitation of the options market maker exception, the Commission has proposed phase-in periods and asked a number of additional questions regarding the need for such phase-in periods and possible duration. Without commenting on the appropriateness or necessity of such phase-in periods, the Committee suggests that, if the Commission adopts phase-in provisions of limited duration, that the Commission draft such provisions as a transitional provision that will expire upon expiration of any phase-in period, rather than, as in the current proposal, embedding those transitional provisions in the permanent portions of the rule. We believe that drafting a transitional provision (covering any temporary changes) that is distinct from on-going requirements will result in a more user-friendly rule.

II. Comments on the Grandfather Provision

A. Proposed Elimination of the Grandfather Provision and Related Questions

Question: Is the elimination of the grandfather provision from the close-out requirement in Rule 203(b)(3) appropriate?

Response: As discussed above, the Committee believes the Commission has not yet adequately explained the need for this change and therefore believes the Commission should not adopt this change unless it can provide substantial evidence supporting the need for this change. Some of the questions posed by the Commission in the Proposing Release suggest that the Commission itself is unsure whether fails themselves are harmful.[7] Assuming that persistent fails are harmful to the securities markets, the Commission has not provided in the Proposing Release any basis to believe that the substantial and persistent fails to deliver observed by the Commission and the SROs are primarily attributable to the grandfather provision, or that a change to this provision would materially reduce the number of persistent fails. As a result, we cannot recommend that the Commission adopt this change without first providing to the public the opportunity to review and comment upon any supportive data the Commission may have.

B. Other Questions Relating to the Close-Out Requirement

In addition to questions specifically relating to the proposed elimination of the grandfather provision, the Commission also posed a number of more general questions relating to the close-out requirement. While we only address a few of these more general questions, we reiterate that if the responses received to these more general questions persuade the Commission that further changes to Regulation SHO are appropriate, the Committee urges the Commission to propose such further changes for notice and comment rather than proceeding directly to adoption.

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[7] For example, the Proposing Release asks the following: "Current Rule 203(b)(3) and the proposal to eliminate the grandfather provision are based on the premise that a high level of fails to deliver for a particular stock might harm the market for that security. In what ways do persistent grandfathered fails to deliver harm market quality for those securities, or otherwise have adverse consequences for investors?" Proposing Release, 71 Fed. Reg. at 41713.

Question: 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?

Response: The Committee believes that all sellers who actually own a security and are permitted a maximum of 35 days after trade date to deliver such securities to their broker-dealer in accordance with Rule 203(b)(2)(ii) of Regulation SHO, not just owners of securities eligible for resale under Rule 144, should be free from risk of being bought in because their clearing firm has a close-out obligation. We understand that it is current industry practice to track fails on an aggregate basis, and it is not reasonably or economically practicable to track fails on an individual transaction-by-transaction (or customer-by-customer) basis.

Question: 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)?

Response: Consistent with our general comment on the importance of evidentiary support, the Commission should not adopt any change to the locate requirement unless the Commission has substantial reason to believe that such changes are necessary. The Commission has not provided, and the Committee is not aware of, any evidence suggesting that sources that decrement are more reliable in terms of providing securities to deliver on short sales. Furthermore, even if such evidence did exist, we believe the locate requirement, as currently written, renders unnecessary the changes suggested by the Commission's question.

Under the locate requirement, broker-dealers need to have and document a reasonable basis to believe shares can be borrowed in time to make delivery with respect to short sales. Thus, whether or not a source for locates decrements shares available to be borrowed, a broker-dealer should be free to rely reasonably on such source to the extent that source consistently makes shares available to such broker-dealer when necessary. To the extent a broker-dealer regularly receives reliable locates form a source that does not decrement, continued reliance on such source is reasonable and should be permitted. Similarly, even if a broker-dealer receives a locate from a source that does decrement, if that source does not regularly have securities available for borrowing when necessary, the broker-dealer likely would not be viewed as having a reasonable basis to believe such source has securities available for delivery. In either event, the rule as currently written adequately addresses both situations and does not appear to need amendment.

Moreover, we believe that requiring such a decrementing process by securities lending sources would be inconsistent with current industry practice, in which broker-dealers often check for the availability of securities for borrowing before they have firm short sale orders in hand. Thus for a securities lending source to decrement based on every inquiry would result in an unnecessary and excessive restriction on shares available for borrowing. We are concerned that such a requirement would impose substantial systems costs and burdens on securities lending sources without any demonstrated corresponding benefit to investor protection.

Question: 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?

Response: The Committee understands that aggregate fail position information is already available to the Commission from the SROs on a security by security basis. If the Commission proposes any public disclosure requirements relative to aggregate fail positions, for purposes of privacy and prevention of short-squeeze manipulation schemes, we recommend that the disclosure not include the identity of the specific persons or entities who have failed.

Question: 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?

Response: Consistent with our earlier comments, we do not believe any additional rules should be adopted, including ones that increase the regulatory compliance and books and records requirements of broker-dealers, without a demonstrated, cost-benefit justified need for such a requirement. Unless there is evidence that a significant portion of overall fails to deliver are the result of customer sales marked as "long," no additional obligations with respect to long sales need to be imposed on broker-dealers.

III. Comments on the Proposed Limitation of the Options Market Maker Exception

A. Proposal and Related Questions

Question: The options market maker exception was created to permit options market makers flexibility in maintaining and adjusting hedges for pre-existing options positions. Is narrowing the options market maker exception appropriate? If not, why not? Will narrowing the exception reduce the willingness of options market makers to make markets in threshold securities? Will narrowing this exception reduce liquidity in threshold securities? Should we consider providing a limited amount of additional time for options market makers to close out after the expiration or liquidation of the hedge (e.g., from 13 days to 20 days)?

Response: As discussed above, the Committee does not believe the Commission has provided adequate information to permit the evaluation of the proposed narrowing of the options market maker exception. The Proposing Release contains absolutely no data or other evidence suggesting that the options market maker exception causes an increase in fails or supporting the notion that elimination of the exception will reduce the amount of fails to deliver in those small number of securities where the Commission has observed persistent, significant fails. We do not believe the proposal will adversely affect the willingness of option market makers to make markets in threshold securities. To the extent options market makers do make markets in threshold securities, they are not doing so in reliance on the options market maker exception since it only encourages options market making in **non-threshold** securities. However, we do believe that this change would be highly likely to adversely affect the willingness of options market makers to make markets in securities which are not yet threshold securities, but are likely to become threshold securities in the near future. This change would therefore decrease the liquidity and reduce the effectiveness of the price discovery process for these securities.

B. Other Questions Relating to the Options Market Maker Exception

In addition to the questions closely related to the options market maker exception, the Proposing Release also has a number of more general questions relating to this exception. Again, the Committee only addresses a few of these more general questions and recommends that the Commission propose changes to Regulation SHO based on the responses submitted to these broader questions.

Question: Should we eliminate the options market maker exception altogether? Would this impede liquidity, or otherwise reduce the willingness of options market makers to make markets in threshold securities? Please provide specific reasons and information to support an alternative recommendation.

Response: We do not believe elimination of the options market maker exception altogether would reduce whatsoever the willingness of options market makers to make markets in threshold securities because the current exception, as written, provides options market makers with no relief from the close-out requirement with respect to their activity in threshold securities. As written, the options market maker exception only provides a benefit to options market makers making a market in **non-threshold** securities; therefore, the existing exception may only encourage options market makers to make markets in non-threshold securities since they do not face the threat of being closed out of their hedged short sales if the underlying security becomes a threshold security after the hedge is made. However, as explained above, we do believe eliminating the options market maker exemption would adversely affect the willingness of options market makers to make markets in securities which are not threshold securities. The result of such a change would be decreased liquidity and reduced price discovery in both the options markets and the markets for the underlying securities. The Commission should only make such a change if it has unequivocal data demonstrating that it would substantially reduce the number of persistent fails and that the resulting benefit to investor protection clearly outweighs costs in terms of liquidity and price discovery.

IV. Conclusion

The Committee appreciates the opportunity to submit these comments. Members of the Committee are available to meet and discuss these matters with the Commission and its staff and to respond to any questions.

Respectfully submitted,

/s/ Keith F. Higgins

Keith F. Higgins
Chair, Committee on Federal Regulation of Securities

<u>Drafting Committee</u>:
W. Hardy Callcott
Michael R. Trocchio
David Aman
Brandon Becker
David M. Chromy
Barbara J. Endres
Trina L. Glass
K. Susan Grafton
Lauren C. Mullen
David Vignola

cc: Hon. Christopher Cox, Chairman
Hon. Paul Atkins, Commissioner
Hon. Roel Campos, Commissioner
Hon. Annette Nazareth, Commissioner
Hon. Kathleen Casey, Commissioner
Brian Cartwright, General Counsel
Dr. Erik Sirri, Director, Division of Market Regulation
Robert Colby, Deputy Director, Division of Market Regulation
James Brigagliano, Acting Associate Director, Division of Market Regulation