



January 30, 2004

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: Short Sales (File No. S7-23-03)

The Securities Industry Association¹ welcomes the opportunity to comment on the proposal by the Securities and Exchange Commission (“Commission”) to overhaul the framework for regulating short sales of equity securities.² In its comments below, SIA also addresses issues raised by the Commission’s recent interpretive release regarding married puts.³

SIA applauds the efforts of the Commission and its staff to modernize the regulation of short sales while more effectively addressing certain abusive short selling practices. These objectives are good for investors, and SIA therefore shares the Commission’s goals. To ensure that regulatory changes are effective in achieving these ends, SIA believes that the Commission should take an incremental approach. This would be preferable to immediate implementation of all of the proposed provisions of Regulation SHO, many of which replace provisions that have been in place in some form for decades. Immediate implementation could disrupt the smooth functioning of financial markets—to the detriment of investors—by unnecessarily upsetting

¹ The Securities Industry Association (“SIA”), established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member firms (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 more than 800,000 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry is projected to generate \$142 billion in domestic revenue and \$283 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

² Proposed new Regulation SHO under the Securities Exchange Act of 1934 (“Exchange Act”) would replace current Rules 3b-3, 10a-1 and 10a-2. Exchange Act Release No. 48,709 (Oct. 29, 2003), 68 Fed. Reg. 62,972 (Nov. 6, 2003) (“Proposing Release”).

³ Exchange Act Release No. 48,795 (Nov. 17, 2003) (“Married Put Release”).

well-established market practices. While some securities firms may be able to accommodate these changes with minimal difficulty, SIA is concerned that others would not be able to do so without incurring considerable costs, especially for the reprogramming and testing of trading and other systems. These costs would adversely affect the ability of such firms to provide liquidity and ultimately would be passed on to customers. Moreover, SIA believes that the Commission needs additional data to be in a position to determine whether the proposed safeguards would achieve their purpose and are worth the burdens that would be imposed.⁴

SIA urges the Commission to address these important issues in phases, rather than all at once. In particular, the Commission should proceed with its proposed pilot program that would exclude certain liquid stocks from all short sale price regulations and, with limited modifications, should implement the proposed uniform locate and delivery provisions, but should otherwise leave in place current short sale price regulations for the time being. Doing so would address the Commission's immediate concerns about naked short selling and extended settlement failures, while allowing the Commission to gather the data necessary to assess the impact of short sale price regulation on the efficient functioning of U.S. securities markets and protection of investors and to ensure consistent regulation across such markets. As a means to reduce regulatory arbitrage and to strengthen regulatory uniformity and consistency, SIA also believes that the Commission should extend current short sale regulation to Nasdaq NMS securities traded away from Nasdaq—*e.g.*, on a national securities exchange on a listed or unlisted trading privileges basis.⁵ SIA addresses its concerns in more detail below.

I. Price Regulation

Proposed Regulation SHO would impose a new uniform price test that would require that short sales in exchange-listed and Nasdaq NMS securities be effected at a price at least one cent above the consolidated best bid at the time of execution. The new test would replace both the tick test governing short sales in exchange-listed securities⁶ and the bid test governing certain short sales in Nasdaq NMS securities.⁷ The Commission also proposes to create a pilot program that would temporarily suspend the operation of the proposed uniform price test for certain liquid securities.

Although the proposed pilot would offer substantial relief from existing short sale price regulation and the proposed bid test may be less restrictive than the current tick test applicable to

⁴ To adopt any rules, the Commission must consider: (1) the costs and benefits of the rules; (2) whether the rules will promote efficiency, competition, and capital formation; and (3) the impact such rules would have on competition. *See* Exchange Act Sections 3(f) and 23(a)(2).

⁵ *See* Proposing Release at 62,979. SIA notes, however, that at least one firm was in favor of maintaining the status quo in this area.

⁶ *See* Rule 10a-1 under the Exchange Act; New York Stock Exchange (“NYSE”) Rule 440B.

⁷ *See* National Association of Securities Dealers (“NASD”) Rule 3350.

listed stocks, the Commission's proposal would otherwise significantly expand short sale price regulation. First, the proposed uniform bid test is far more restrictive than the bid test that currently applies to certain short sales of Nasdaq NMS stocks. Second, the Commission has indicated that Regulation SHO would subject Nasdaq NMS stocks to short sale price regulation after the 4:00 p.m. market close. Third, the Commission proposes to subject certain offshore transactions in covered stocks to short sale price regulation. Fourth, the accompanying Married Put Release could be read to subject numerous additional trading strategies to short sale price regulation.

A. General Approach

SIA commends the Commission for proposing a pilot program that would temporarily suspend price regulation of short sales of certain liquid stocks. The pilot program, together with the uniform locate and delivery requirements, would represent substantial progress in the Commission's efforts to modernize short sale regulation and eliminate certain abusive short selling practices. SIA urges the Commission, however, to leave the other requirements of current short sale price regulation in place to allow time for the pilot to run its course.⁸

The pilot would enable the Commission to evaluate the extent to which short sale price regulation is beneficial to the U.S. capital markets.⁹ As a general matter, any price test—whether a bid test or a tick test—constitutes government regulation of the price at which market participants are willing to trade and should be scrutinized carefully. Until the Commission has had the opportunity to study the pilot data and to evaluate trading behavior in the absence of short sale price restrictions, SIA believes that it is premature to adopt a new price test. The costs of requiring investors and brokerage firms to comply with the bid test proposed in Regulation SHO during the course of the pilot program would outweigh any benefits that would be realized in that period. Implementation of the proposed bid test would require firms to update trading, surveillance, order management and other systems. These systems updates would be expensive and time consuming. As importantly, the updated systems could be obsolete within two years if the Commission proposes or adopts additional changes to Regulation SHO upon completion of the pilot program. On top of these costs, the implementation of the pilot program itself would require additional expenses because certain securities would be subject to the proposed price test while others would not, potentially requiring additional programming.¹⁰

⁸ As noted earlier, the exception may be to extend current short sale regulation to Nasdaq NMS securities traded away from Nasdaq.

⁹ The Proposing Release recognizes two important benefits of short selling: market liquidity and pricing efficiency. Proposing Release at 62,974 (citing Owen A. Lamont and Richard H. Thaler, *Can the Market Add and Subtract? Mispricing in Tech Stocks Carve-outs*, NBER Working Paper w8302 (2001)).

¹⁰ SIA notes that any change proposed by the Commission will affect, at a minimum, firms' trading, surveillance, order management, stock loan and other systems, and therefore requests
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In contrast, after analyzing the pilot data, the Commission will be in a better position to analyze the benefits of price regulation, the extent to which those benefits justify a departure from free market principles, and how any such price regulation should be designed. SIA urges the Commission to assess this data in light of the following considerations. Short sale price regulation imposes additional costs on investors that are implementing legitimate and often beneficial trading strategies. Short sale price regulation (and the other proposed short sale requirements) may unnecessarily impair the effectiveness of short selling as a mechanism to combat artificial price inflation due to irrational market exuberance and unrealistically high stock prices caused by overly optimistic (or untruthful) issuer management. If such pricing bubbles go unchecked, the harm to investors is more severe when these bubbles burst. The Commission should thus consider the extent to which (a) prophylactic restrictions on short selling restrain the potentially corrective force of investors willing to sell short, and (b) rigorous enforcement of current laws prohibiting market manipulation would obviate or minimize the need for prophylactic price regulation.

SIA also asks the Commission to take into account the fact that short sale price regulation also hampers market liquidity and efficiency. Trading strategies that require short exposure to a covered stock—for example, to hedge other long exposures—have no relation to the bear raids that Rule 10a-1 was designed to prevent. These legitimate trading strategies are more expensive when short sale prices are regulated. Further, on every short sale, there is a buyer on the other side who benefits from the additional liquidity provided by the short seller.¹¹

In sum, by implementing the pilot program before making dramatic changes to current short sale price regulation, the Commission would be able to evaluate whether hard data—and not just complaints and other anecdotal evidence of stock price declines—shows that short sale price regulation is warranted. If the pilot data evidences that comprehensive short sale price regulation is warranted, the pilot data would help the Commission determine how it can best tailor any price regulation to maximize the intended benefits and minimize the costs to the markets.

B. The Proposed Pilot

While, as noted above, SIA supports the concept of a pilot program, SIA urges the Commission to change its method for selecting stocks for the pilot. According to the Proposing

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that the Commission give firms substantial lead time for implementation and testing of any such changes.

¹¹ It is significant that other jurisdictions have considered implementing short sale price regulations and have decided not to do so. In the United Kingdom, for example, the Financial Services Authority (“FSA”) has taken the view that potential short selling abuses can be adequately addressed through its general framework of trading rules, including consumer suitability, prudential safeguards, orderly markets, fair trading practices, and efficient settlement. *See* Financial Services Authority, Discussion Paper 17, Short Selling, at 15 (Oct. 2002).

Release, “the Commission would consider including in the pilot one-third of the securities in the Russell 1000 Index.... We would sort the Russell 1000 by average daily dollar volume over the calendar year prior to the start of the pilot and use an objective method that would create two samples that should be approximately similar in average market value and average volume.”¹² SIA appreciates that this method might enable the Commission to conduct the most statistically valid study possible. While this is a laudable goal, SIA believes that it also is important to weigh the practical consequences of dividing stocks in this manner. For example, structuring the pilot program in this fashion may make it too difficult to implement and therefore discourage firms from making the necessary systems and other changes in some or all stocks, thus skewing the results.

A more appropriate group of stocks for a test group may be those that currently qualify for the Regulation M exception for actively traded securities.¹³ In adopting Regulation M, the Commission concluded that the excepted stocks are less susceptible to market manipulation.¹⁴ The cost of implementing the pilot may be reduced if these Regulation M-excepted stocks were covered because many broker-dealers already have systems in place to identify these stocks for Regulation M purposes. In the alternative, the Commission might consider using the component securities of one or more broad-based indices, such as the S&P 500 and Nasdaq-100, as the basis for the pilot’s test group with other securities, such as those in the Russell 1000 Index that are not included in the test indices, composing the control group.

SIA further recommends that the Commission not suspend the pilot program during extraordinary market conditions. The Proposing Release recognizes that the pilot will “provide data on advancing and declining markets, high volume and low volume, and different stages of volatility so that the suspension can be studied fully.”¹⁵ The pilot would be most effective if it functions under the widest range of potential market conditions.¹⁶ Moreover, short sale price regulation is not effectively used as a backstop against price declines or volatility. Rather, short sale price regulation is a tool for preventing abusive trading that will artificially affect market prices. Abandoning the pilot under extraordinary market conditions would not further this goal and would require firms to make modifications to allow their systems to change the securities subject to the restrictions of Regulation SHO on an ad hoc basis.

¹² Proposing Release at 62,983.

¹³ The exception under Rule 101 of Regulation M applies to those securities that have an ADTV value of at least \$1 million and that are issued by an issuer whose common equity securities have a public float value of at least \$150 million. *See* 17 CFR 242.101(c)(1).

¹⁴ *See* Exchange Act Release No. 38,067 (Dec. 20, 1996), 62 Fed. Reg. 520 (Jan. 3, 1997).

¹⁵ Proposing Release at 62,984.

¹⁶ Similarly, rules of the self regulatory organizations (“SROs”) restricting activities during extraordinary market conditions, such as NYSE Rule 80A, should not apply to securities included in the pilot.

Lastly, SIA suggests that the Commission consider a pilot program of shorter duration. For example, a six-month or twelve-month pilot program may be sufficient to provide data on a variety of market conditions. Alternatively, the Commission might consider reviewing data from the pilot program prior to the program's end on a rolling basis after a minimum sampling period has elapsed. These measures would help bring much needed stability to the market as soon as possible.¹⁷

C. Specific Comments on the Proposed Uniform Bid Test

If the Commission decides to proceed with the adoption of the uniform bid test at this time, despite the downsides outlined above, SIA requests that the Commission address the following issues to ensure that this new bid test is tailored to avoid unintended adverse consequences for investors and markets.

1. Bid Test Design

The Proposing Release seeks comment on whether an alternative bid test that allows short selling at a price equal to or above the consolidated best bid if the current best bid is above the previous bid (*i.e.*, an upbid) would be preferable.¹⁸ SIA believes that this alternative bid test is superior to the proposed bid test (a penny over the best bid in all cases) and is similar to the NASD's current bid test, which works relatively well.¹⁹ The Proposing Release does not present evidence that more burdensome price restrictions would be more effective at preventing bear raids and the other abuses that short sale price regulation is designed to prevent.²⁰

Requiring all short sales to be effected at a penny over the best bid would slow the speed of executions and impose unnecessary costs on market participants, including the vast majority who are effecting legitimate and market beneficial trading strategies. Although a penny may not seem like a large amount, this change would have significant consequences. If implemented as proposed, Regulation SHO would, in effect, prohibit all investors that sell short from hitting the

¹⁷ SIA urges the Commission to publish the data collected from the pilot. By making this data available to the public for review and analysis, the Commission can ensure that the rulemaking process remains open and transparent, and that the Commission receives the benefit of further comment and input from the industry and investors.

¹⁸ Proposing Release at 62,980.

¹⁹ For example, SIA believes that it would be more efficient and economical for firms to adapt existing systems for compliance with the NASD's bid test to cover all the securities subject to Regulation SHO, than for firms to modify their systems or to design new systems to accommodate the new bid test proposed in Regulation SHO.

²⁰ Short selling abuses include exacerbation of "a declining market in a security by increasing pressure from the sell-side, eliminating bids, and causing a further reduction in the price of a security by creating an appearance that the security price is falling for fundamental reasons." Proposing Release at 62,974.

best published bid, even when the best bid is trending upward.²¹ Any price regulation that prohibits short sellers from hitting the best published bid also hurts buyers because there would be fewer sellers able to meet their published buying demand. This limitation on liquidity would likely cause buyers to obtain less desirable executions of their orders. Overall, public investors and markets would not be well served.

The Proposing Release explains that one of the objectives of the proposed bid test is to prevent short sellers from exhausting higher priced bids on a stock to cause a price decline.²² SIA believes this concern is unfounded. Every trade, whether a purchase or a sale, potentially exhausts existing trading interest at a given price. The exhaustion of bids is not a phenomenon unique to short selling, and the Commission's objectives would not be furthered by prohibiting short sellers from hitting the best published bid. Indeed, the same reasoning would justify an "offer test" applicable to purchases to prevent buyers from driving up the price of a stock.

2. Hours of Price Regulation

The Commission should limit any short sale price regulation to the regular trading hours of the principal national securities exchanges in the United States (currently 9:30 a.m. to 4:00 p.m.). Extending short sale price regulation to after hours trading would do little to advance the Commission's goal of preventing manipulative short selling and would impede legitimate trading strategies.

The Proposing Release presents no evidence that manipulation of after hours markets is a problem or that price regulation of short sales in those markets will be an effective tool to prevent such manipulation. Since the NASD first implemented its bid test in 1994,²³ the test has not applied after 4:00 p.m. SIA is not aware of any post-1994 Commission enforcement case for an after hours bear raid.

After regular market hours, investors watch the tape far less closely, and those who do are typically sophisticated investors.²⁴ Investors who transact after hours consider the prices of

²¹ In addition, flickering quotes in active securities not included in the pilot may create the appearance that short sale orders are being inappropriately executed. As the Proposing Release notes, price flickering has increased as a result of decimalization. *See* Proposing Release at 62,981.

²² *See* Proposing Release at 62,980.

²³ *See* Exchange Act Release No. 34,277 (June 29, 1994).

²⁴ If at some point in the future, retail investors become more active in after hours trading, the Commission could consider ensuring that they are well informed about the risks of trading after hours. For example, the staff of the Commission's Division of Market Regulation recently made several recommendations designed to maximize protections and minimize confusion for investors participating in after hours trading. *See Special Study: Electronic Communication Networks and After-Hours Trading* (June 2000), *available at* <http://www.sec.gov/news/studies/ecnafter.htm>.

after hours trades with circumspection because there typically is less liquidity available. Trades executed outside normal market hours are designated as such through modifiers that show that the trades were made outside of normal market hours.²⁵ These modifiers signal to the market that the prices of these trades do not reflect the more robust liquidity that is typically available during market hours.

If the Commission does not agree with this approach, SIA recommends, in the alternative, that the Commission not impose any short sale price regulation after both the consolidated tape and the Nasdaq tape close. The bear raids that short sale price regulation is designed to prevent rely on the reaction of investors who see declining prices on the tape. At its core, a bear raid is thus a form of “painting the tape.” After the consolidated tape closes, there is no tape to paint. Although trades effected after the tape closes are reported the next day, by then, the information is largely stale. As a result, it would be difficult to conduct a bear raid once the tape has closed.

Limiting short sale price regulation to market hours also would avoid raising difficult issues with respect to the application of U.S. short sale regulations to offshore trades (as discussed in the next section) and would provide broker-dealers with the flexibility necessary to facilitate orders for customers who want to buy stock after hours. If short sales conducted after hours were not covered by short sale price regulations, the question of whether short sale price regulations apply to an after hours trade negotiated in the United States and effected overseas would be moot because these trades could be effected after hours without regard to U.S. short sale regulations. If the Commission does further extend short sale price regulation in after hours markets, then the exceptions discussed below in Section II become increasingly important.

3. The Proposed Treatment of Offshore Crosses

SIA disagrees with the assertion in the Proposing Release that it is clear under current law that the Rule 10a-1 tick test applies to all transactions that are “booked” overseas if those transactions are agreed to in the United States.²⁶ SIA also opposes applying such a rule

²⁵ Under NASD Rule 5430, last sale reports of Nasdaq NMS transactions executed between midnight and 9:30 a.m. or between 4:00 p.m. and 6:30 p.m. are designated as “.T” trades to denote their execution outside normal market hours. Trades executed between 8:00 a.m. and 9:30 a.m. or 4:00 p.m. and 6:30 p.m. must be reported within 90 seconds of execution. If a trade is executed between midnight and 8:00 a.m., it is not reported until at least 8:00 a.m. Transactions that are executed after 6:30 p.m. are reported the next business day and designated “as/of” trades to show that they were executed on a prior day. NASD Rule 6420 applies similar rules to over-the-counter transactions in listed securities that are required to be reported to the consolidated tape.

²⁶ On a related note, SIA suggests, going forward, that instead of using the term “booked,” the Commission use terms better defined and understood under the federal securities laws, such as effected, executed, or reported.

prospectively because doing so would provide little benefit to U.S. markets and would preclude a number of legitimate trading strategies.²⁷

The Commission and SROs have long been aware that U.S. institutions effect trades overseas without treating those trades as subject to U.S. short sale regulations and have not brought any enforcement actions or announced that this practice is improper.²⁸ Despite the regulators' long-standing acquiescence to such practices, the Proposing Release states that "[c]onsistent with prior Commission action, [the Commission views] short sale regulation as applying to trades in reported securities when the trade is agreed to in the United States, even if the trade is 'booked' overseas."²⁹ The Proposing Release cites to three releases in support of this position,³⁰ but SIA believes that these releases do not support this expansive interpretation of the extraterritorial application of Rule 10a-1.

First, the Proposing Release notes that, in the 1985 Release discussing the globalization of securities markets, the Commission wrote "Rule 10a-1 does not contain any exemption for short sales effected in international markets." While this statement is certainly accurate, the absence of an express exemption for international short sales does not mean that international short sales in listed securities are subject to Rule 10a-1.³¹ Further, the fact that there is not an exemption for short sales effected in international markets need not be indicative of any intent by the Commission to apply Rule 10a-1 to such trades.

Second, the Proposing Release cites the 1990 Release in which the Commission concluded that an earlier no-action position covering the liquidation of certain index arbitrage positions did not apply to an index arbitrage position that was established in an offshore

²⁷ SIA believes there is no indication that offshore short sales have had any negative impacts on markets in the United States.

²⁸ See, e.g., Exchange Act Release No. 30,920 (July 14, 1992), 57 Fed. Reg. 32,587 (July 22, 1992) (observing that "a portion of foreign trading in U.S. equities by U.S. broker-dealers or institutions is done to avoid off-board trading restrictions, transparency standards in the U.S. markets, transaction fees and other rules, such as the Commission's short sale rule, as well as cost considerations.").

²⁹ Proposing Release at 62,997.

³⁰ *Id.* at n. 220. This footnote cites Exchange Act Release No. 21,958 (Apr. 18, 1985), 50 Fed. Reg. 16,302, 16306 n. 48 (Apr. 25, 1985) ("1985 Release"); Exchange Act Release No. 27,938 (Apr. 23, 1990), 55 Fed. Reg. 17,949 (Apr. 30, 1990) ("1990 Release"); and Exchange Act Release No. 28,899 (Feb. 20, 1991), 56 Fed. Reg. 8,377 (Feb. 28, 1991) ("1991 Release").

³¹ Such an exemption is not necessary because Rule 10a-1 does not apply to short sales executed abroad, either under Rule 10a-1(a) or 10a-1(b). Such trades are not covered by Rule 10a-1(a) because they are neither reported nor documented under a U.S. transaction reporting plan. In addition, trades booked outside the United States are not subject to Rule 10a-1(b) because they are not effected on a national securities exchange.

transaction unless the holder acquired the securities from a seller that acted in compliance with Rule 10a-1 or other comparable provision of foreign law. The position taken by the Commission in that context does not mean that Rule 10a-1 applies to all short sale transactions agreed to in the United States but instead requires that, to obtain the index arbitrage exemption, the seller of the securities in question must have complied with either Rule 10a-1 or the applicable foreign short selling law.³²

Finally, the Proposing Release cites the 1991 Release in which the Commission determined that “trades negotiated in the U.S. on a U.S. exchange are domestic, not foreign trades.” This statement was originally issued to clarify that time-stamping in London for purposes of NYSE Rule 390 did not affect a computerized, “single price” auction system operator’s obligations to comply with U.S. recordkeeping and reporting requirements. This concept was further noted in a report demonstrating a long-standing awareness that U.S. broker-dealers had been effecting trades negotiated in the United States through foreign desks or affiliates to avoid U.S. regulations, including short sale rules.³³ In the Market 2000 Report, the staff of the Commission’s Division of Market Regulation recommended that “the U.S. transaction reporting system should capture trades in reported securities when the price discovery occurs in the United States, but the trades are nominally booked overseas for execution.”³⁴ At most, these statements suggest a need for the tightening of regulations with respect to the U.S. transaction reporting system.

Even if these prior statements regarding the extension of U.S. reporting rules to certain trades executed abroad do constitute a proper formulation of law, the Commission has not indicated that short sale regulations should be similarly applied. In the Market 2000 Report, the staff did not recommend the application of short selling rules to all trades negotiated in the United States. Even after acknowledging the practice of trading offshore for the alleged purpose of avoiding the application of Rule 10a-1, the staff did not state or imply that this practice is improper or illegal. Moreover, U.S. institutions have historically effected a significant number of trades abroad after the close of regular trading hours, and such trades have not been subject to the same regulations that would apply if the same trades were effected in the United States.

³² Even if the Commission’s interpretation of the index arbitrage exemption is expanded to cover all short sales, SIA believes that transactions executed by U.S. institutions abroad should only be required to comply with laws governing short sales in the jurisdiction where the trade was reported, not the Rule 10a-1 tick test, and may not be subject to short sale price regulation at all. For example, short sales executed in London are regulated through the FSA’s general framework of trading rules, which do not require compliance with a tick test or similar price test. *See supra* note 11. Although such trades are not subject to short sale price regulation like that imposed by Rule 10a-1, they are nevertheless governed by a “comparable provision of foreign law.”

³³ *See* Division of Market Regulation, SEC, Market 2000: An Examination of Current Equity Market Developments (Jan. 1994), Study VII (“Market 2000 Report”).

³⁴ Market 2000 Report at 2.

In an increasingly global marketplace, there is a need to clarify the distinction between a U.S. trade and a foreign trade. SIA believes, however, that any such clarification should be made through a separate rulemaking proceeding in compliance with the requirements of the Administrative Procedures Act (“APA”).³⁵ A “rule” is defined for purposes of the APA as “the whole or a part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements of an agency and includes the approval or prescription for the future of rates, wages, corporate or financial structures or reorganizations thereof, prices, facilities, appliances, services or allowances therefore or of valuations, costs, or accounting, or practices bearing on any of the foregoing.”³⁶ The definition of a U.S. trade versus a foreign trade, whether solely for trade reporting purposes or as it would apply to all U.S. securities laws, would qualify as a rule under this definition as “a statement of general or particular applicability and future effect” designed to define the scope of any regulations to which it applies.

In addition, SIA urges the Commission to reconsider the implications of its proposal to expand application of U.S. short sale price regulations in light of its potential inconsistency with other securities regulations, particularly Rule 15a-6. Under Rule 15a-6, a foreign broker-dealer is permitted to interact with U.S. customers without registering as a broker-dealer in the United States provided that the foreign broker-dealer complies with certain conditions imposed by the rule.³⁷ A better standard for application of U.S. short sale price regulation would recognize that, in most cases, trades executed outside the United States should be subject to the laws of the local jurisdiction where they are executed. Therefore, SIA believes that the Commission should make clear that short sale price regulations do not and will not apply to transactions effected by foreign broker dealers in compliance with Rule 15a-6(a)(3) or (a)(4).

4. Basing Price Regulation on the Consolidated Best Bid

While SIA applauds the Commission’s efforts to create a uniform price test across all markets, SIA notes that differences in the reliability and speed of markets may limit the effectiveness of the proposed price test. By moving to a test based on the consolidated best bid, the proposed test may direct short sales to the market posting the best bid, because such sales are more likely to be executed there. If the market posting the best bid is less reliable or slower than other markets, investors may receive worse executions than would otherwise have been

³⁵ Under the APA, an agency may not adopt a final rule unless it publishes a notice of proposed rulemaking and provides the public with an opportunity to comment on the proposed rule. 5 U.S.C. § 553.

³⁶ 5 U.S.C. § 551(4).

³⁷ This exemption from registration reflects the principle that the trading activity of foreign broker-dealers under Rule 15a-6 is more properly regulated in the jurisdiction where it is executed. The safeguards of Rule 15a-6 are carefully designed to ensure that covered transactions are *bona fide* offshore transactions that do not warrant the full panoply of U.S. securities regulation.

available. Despite this risk, SIA agrees with the Commission that bid-based price regulation is preferable to print-based price regulation. However, SIA urges the Commission, in order to reduce costs incurred by market participants chasing ephemeral quotes, to adopt measures that will ensure that bid prices are firm and accessible.

II. Exceptions

There are currently a number of exemptions and exceptions to short sale price regulations designed to permit certain types of trading activities that are viewed as either beneficial to the markets or posing little risk of abuse. The Commission proposes to include most of these exemptions and exceptions in Regulation SHO, with a few modifications. While SIA generally supports this approach, several modifications are warranted.

A. Domestic Arbitrage Exception

The domestic arbitrage exception in proposed Rule 201(d)(5) would permit short sales effected in *bona fide* arbitrage transactions involving convertible, exchangeable, and other rights to acquire the securities sold short. This exception would require that the acquired rights be attached to or represented by another security, or be issued to all the holders of any such class of securities. In addition, the Commission believes that the short seller must subsequently acquire or purchase the security upon which the arbitrage is based.³⁸ In contrast, the existing domestic arbitrage exception in Rule 10a-1(e)(7) does not require the subsequent acquisition or purchase of the securities upon which the arbitrage is based. SIA urges the Commission to drop the proposed acquisition/purchase requirement.³⁹

This exception should not favor conversion and delivery over simultaneously closing out both sides of the arbitrage. Like the Commission, SIA believes that a *bona fide* arbitrage consists of a genuine effort to profit from an existing price differential.⁴⁰ It is not uncommon for an arbitrageur to determine that unwinding both sides of a *bona fide* arbitrage is more efficient or desirable than conversion and delivery. There are many reasons why an arbitrageur may unwind both sides, such as the cost of carrying the positions may increase, borrowed stock may be recalled by the lender, or a convertible security may not reach its conversion price. For example, a person selling short an equity security may decide to hedge that position with a long instrument convertible into the short equity security. Such arbitrageur may have a difficult time financing the short position if the delivery period after tendering the convertible instrument is relatively lengthy (e.g., 2 or 3 weeks), and, in this case, the arbitrageur would legitimately prefer to unwind both sides rather than convert and await delivery.

³⁸ Proposing Release at 62,985 n.116.

³⁹ As an aside, SIA suggests a technical correction in Rule 201(d)(5): changing “arbitrage account” to “good faith account.” In 1998, arbitrage accounts (formerly 12 CFR. 220.7) were replaced under Regulation T by good faith accounts (12 CFR 220.6). See 63 Fed. Reg. 2,805 (Jan. 16, 1998).

⁴⁰ See Exchange Act Release No. 15,533 (Jan. 29, 1979).

The Proposing Release did not describe any abuses that would justify this change to existing law, and SIA is not aware of any. Moreover, the Commission has long recognized that *bona fide* arbitrage is beneficial to markets in that it tends to reduce pricing disparities.⁴¹ Thus, SIA urges the Commission to consider the reduced benefit to the market from lessened arbitrage activities that will result from requiring delivery and conversion.

B. Merger Arbitrage Exception

The Proposing Release asks whether short sales effected in connection with a merger arbitrage should be excepted from the provisions of Rule 201. SIA urges the Commission to add a merger arbitrage exception to Regulation SHO.⁴² While the Proposing Release correctly notes that the right to acquire another security in a merger scenario arises only by the terms of the merger agreement and not through a right vested in the security itself, this distinction does not provide a policy basis for excluding merger arbitrage from the exceptions in the current rulemaking effort. Indeed, other provisions of the federal securities laws contain exceptions for merger arbitrage and, more generally, risk arbitrage activities.⁴³

As a related matter, SIA urges the Commission to consider treating a party who is entitled to receive stock at a date certain under the terms of a finalized merger agreement as essentially in the same position as a person who has entered into an unconditional purchase contract for the same stock. A party to such a forward purchase agreement would be considered long by virtue of the unconditional agreement, and if such party subsequently sold shares, the sales would be long sales. The economically equivalent position of the person who is an implied third party beneficiary of the merger agreement should be accorded the same treatment.

C. Exception for Market Makers and Specialists

The Proposing Release asks whether there should be a blanket exception from the provisions of Regulation SHO for *bona fide* market making, similar to the one found in NASD Rule 3350(c). In SIA's view, the Commission is unduly skeptical of the need for adopting such a blanket exception.⁴⁴ Even if, as the Proposing Release suggests, the need for market makers and specialists to sell at or below the best bid is limited, SIA believes that Regulation SHO

⁴¹ *Id.*

⁴² SIA offers to work with the Commission to develop criteria for determining when in the merger process a party can be deemed to be entitled to acquire securities under a merger agreement.

⁴³ Section 11(a)(1)(D) of the Exchange Act exempts "risk arbitrage transactions in connection with a merger, acquisition, tender offer, or similar transaction involving a recapitalization" from the general prohibitions imposed on exchange members, preventing them from effecting transactions for their own accounts on their respective exchanges.

⁴⁴ See Proposing Release at 62,989 n.153 ("a market maker should rarely need to sell short at or below the bid in its market making capacity.").

should include an exception to support that need.⁴⁵ While SIA agrees with the Commission that market makers should not be able to avail themselves of such an exception for activities outside the scope of their market making activities, such as speculative selling strategies, SIA believes that a market maker exception would indeed enhance liquidity by permitting market makers to adjust inventory positions quickly and in a means consistent with their SRO obligations, including the affirmative and negative obligations of specialists.

In recognition of their contribution to the marketplace, market makers and exchange specialists are consistently accorded regulatory treatment supporting their market-making role.⁴⁶ Indeed, the Commission recognizes the policy goal of facilitating the market-making role in the proposed specialist and market maker exception to the proposed “locate” requirement. The Commission stated that “a narrow exception for market makers and specialists engaged in bona fide market making activities is necessary because they may need to facilitate customer orders in a fast moving market without possible delays associated with complying with the proposed ‘locate’ rule.”⁴⁷

As an alternative to a blanket exception, SIA requests that the Commission at a minimum provide tailored exceptions for market makers under special circumstances. For example, Regulation SHO should include an exception for so-called “print protection” transactions to allow a registered specialist or market maker to sell short to fill a customer buy order at the last reported price on another market when such transaction took place at or below the consolidated best bid.⁴⁸ Market makers should also be excepted from the bid test when selling into a bid to clear locked or crossed markets. Remediation of such anomalous market conditions is a highly beneficial function performed by market makers.

In addition, SIA supports the extension of a blanket market making exception to options market makers and specialists registered as such on U.S. options exchanges (“OMMs”) for sales effected as *bona fide* hedges to contemporaneously executed or pre-existing long-side options positions in the OMMs’ market maker accounts. SIA envisions this exception as similar to the

⁴⁵ Proposing Release at 62,989 n.154.

⁴⁶ For example, Regulation T allows a creditor to extend credit with good faith margin to any “member of a national securities exchange or registered broker or dealer to finance its activities as a market maker or specialist.” 12 CFR 220.7(g)(5).

⁴⁷ Proposing Release at 62,977.

⁴⁸ For example, when a specialist or market maker on a regional exchange holds a limit order in a security traded on both the regional exchange and a primary exchange, such as the NYSE, the specialist or market maker may guarantee that it will execute the limit order in whole or in part whenever a transaction occurs at the limit price on the primary exchange in that security. *See, e.g.*, BSE Chap. II, Section 33(c); CHX Art. XX, Rule 37(a)(3); NSX Rule 11.9(u), Interp. .02. Providing the execution at the primary market price is known as primary market print protection.

provisions of NASD Rule 3350(h), which permits NASD members to execute short sales for the account of OMMs if such sales are considered “exempt hedge transactions.” SIA believes that this exemption is heavily relied upon by OMMs and is not aware of any enforcement actions alleging abuses of this short sale exemption by OMMs.⁴⁹

To satisfy their affirmative and negative obligations with respect to their assigned options classes, OMMs make substantial commitments of capital in highly leveraged equity-option and index-option products, often under circumstances involving significant market risk. When customers of an OMM place short-side options orders (*i.e.*, long puts and short calls), the OMM is often unaware of the events precipitating the orders, such as breaking news relating to an individual security or the market in general. OMMs rely on their ability to hedge on a relative value basis in order to offset some of the risk of providing options liquidity in volatile markets.

In stock markets, a specialist or market maker can often sell purchased stock back into the market at the bid if the risk of the stock position is too great (aggregation issues notwithstanding) and thereby minimize losses. In the options markets, however, OMMs cannot easily offset the risk of assuming a short-side options position in a down market. Under these circumstances, OMMs become “long” in delta terms but not long in actual shares. Permitting OMMs to offset such risk in the stock market by selling a delta equivalent amount of shares would better ensure that derivative markets meet customer demands.

D. Exception for Volume-Weighted Average Price Transactions

Proposed Rule 201(d)(8) would codify prior exemptive letters and except short sales executed on a volume weighted average price (“VWAP”) basis, arranged or “matched” before the market opens at 9:30 a.m., and assigned a price after the close of trading when the VWAP is calculated (provided that they meet certain other conditions set forth in the staff’s prior no-action letters).⁵⁰ SIA strongly supports the inclusion of this exception in Regulation SHO but requests certain modifications.

First, SIA asks that the Commission extend the scope of the exception to apply to VWAP orders by broker-dealers. While past exemptive letters applied to customer short sale orders,⁵¹ SIA sees no policy basis to distinguish between VWAP short sale orders submitted by broker-dealers and other persons.

⁴⁹ Although there is no current exemption under Rule 10a-1 for OMMs, the Commission did not offer a policy rationale why OMMs should be treated differently under the NASD rule than under Rule 10a-1 in the release adopting the NASD’s short sale bid test. *See* Exchange Act Release No. 34,277 (June 29, 1994).

⁵⁰ Proposing Release at 62,982.

⁵¹ *Id.* at n. 87. On this point, SIA notes that the proposed 10% volume limitation in Rule 201(d)(8)(vii) specifically applies to “customer short sale orders,” and it is unclear whether usage of the term “customer” is intended to be limiting in this context.

Second, the Commission should extend comparable relief to intraday VWAP orders—*i.e.*, VWAP orders placed after the open or that terminate before the close (or both). Such orders are becoming increasingly important tools for investors and, like the currently exempted all-day VWAP orders, present limited potential for abuse. VWAP transactions generally are an extremely inefficient way to engage in short sale activities with the intent of profiting later from declining prices. Because a VWAP short seller cannot predict in advance what will be the final VWAP value or whether it would constitute a price that is a penny over the best bid, the application of a short sale price test to these transactions may make it difficult—if not impossible—for the parties to execute a VWAP order on the terms they negotiated.

Third, SIA asks that the Commission deem the broker-dealer facilitating a customer's VWAP sell order as long or short exempt without regard to such broker-dealer's other proprietary positions because such broker-dealer has no incentive to depress the stock price.⁵² The facilitating broker-dealer's incentive would be to work off its risk by selling the security at attractive prices—*i.e.*, at a higher price than the expected VWAP—throughout the day (or for a shorter interval for intraday VWAP). Indeed, successful sales by a facilitating broker-dealer that “beat” the final VWAP would enable the broker-dealer to keep the differences between the VWAP (at which the security is purchased from the customer) and the prices at which the security is sold as trading profits.⁵³

III. Locate and Delivery Requirements

SIA supports the adoption of uniform locate and delivery requirements for short sales. In SIA's view, the locate and delivery requirements proposed in Regulation SHO (with certain modifications discussed in more detail below) would alleviate the problems of naked short selling and extended fails to deliver and would enhance the operation, integrity and stability of the clearance and settlement system.

Proposed Rule 203(b)(1) would prohibit a broker-dealer from executing a short sale order for its own account or the account of another person unless the broker-dealer or the person for whose account the short sale is executed: (i) borrowed the security or entered into a *bona fide* arrangement to borrow the security; or (ii) had reasonable grounds to believe that it could borrow the security so that it would be capable of delivering the securities on the date delivery is due.

⁵² In this regard, SIA notes that the proposed exception for riskless principal transactions under Rule 201(d)(9) would not be useful because of the Commission's belief that the offsetting transaction to a customer's order should be allocated to such customer within 60 seconds. More generally, SIA believes that the riskless principal exception is not flexible enough to allow meaningful facilitation activities by broker-dealers.

⁵³ In the alternative, the facilitating broker-dealer, as a party that “has purchased, or has entered into an unconditional contract, binding on both parties thereto, to purchase” the security, could be deemed long (absent an offsetting short position). As discussed in greater detail below in Section IV.A, SIA believes that formulaic pricing rather than fixed pricing should not preclude a broker-dealer that is facilitating a customer order from being deemed “long.”

Proposed Rule 203(b)(3) would impose certain penalties for extended fails on short sales of securities with a specified rate of settlement failures.

A. Standard for Locates

Under proposed Rule 203(b)(1), a broker-dealer could execute a short sale for its own account or the account of another person if the broker-dealer or the person for whose account the short sale is executed has reasonable grounds to believe that it could borrow the security so that it would be capable of delivering the securities on settlement date. The Proposing Release solicits comment on how broker-dealers effecting short sales could establish the “reasonable grounds” required by the proposed rule. SIA urges the Commission to interpret the “reasonable grounds” requirement in a manner that recognizes certain long-standing market practices that have worked well in the vast majority of short sales.

First, the Commission should allow broker-dealers to continue to reasonably rely on so-called “easy to borrow” lists. In developing “easy to borrow” lists, broker-dealer stock loan desks use information from a number of sources, including institutional lenders that have sophisticated systems for estimating borrow supply. Broker-dealer stock loan desks may also consider the availability of inventory at their own firms and potential availability from other broker-dealers that act as conduit lenders. Much of this information is available through electronic feeds and is updated frequently. “Easy to borrow” lists have become an efficient and reliable tool for assessing stock loan/borrow liquidity and preventing settlement failures.

Second, to eliminate uncertainty, the SIA requests that the Commission explicitly reaffirm that broker-dealers may rely on a representation from a customer that the customer has located stock to borrow.⁵⁴ The NASD currently interprets its rules to allow members to do so.⁵⁵ For many years, NYSE member organizations have understood that the same was true under NYSE Rule 440C.10 Interpretation /01. As SIA previously has discussed with the staff of the Commission’s Division of Market Regulation, the NYSE recently has been criticizing certain member organizations for obtaining assurances relating to the availability of shares for delivery from their customers (especially in the prime brokerage context).

In light of these conflicting interpretations, the Commission should issue definitive guidance that broker-dealers may obtain and rely on customer assurances as to the availability of

⁵⁴ The language of proposed Rule 203(b)(ii) supports this interpretation because it allows “the person for whose account the short sale is executed” to locate the stock. In certain circumstances, such as for short sale orders transmitted electronically, reliance on assurances provided by the customer may be the only practicable method of compliance with the locate requirement.

⁵⁵ The NASD has explained that a member would be in compliance with the “affirmative determination” requirement in NASD Rule 3370(b)(2)(A) if the member “specifically ask[s] the customer whether the securities will be delivered by settlement.” NASD Notice to Members 86-69 (Oct. 10, 1986).

shares for delivery. The SIA believes that this practice is widely accepted, as is reliance on customers' representations as to whether a sale is long, and that relying on customers' assurances as to availability has been an effective means of assessing the current lending market. Furthermore, reliance upon customers' representations is just part of the overall efforts of broker-dealers to monitor locate requirements as evidenced by appropriate internal controls and policies and procedures.

Moreover, absent the existence of red flags or other special situations, broker-dealers should not be obligated to verify their customers' representations as to the availability of shares for delivery. To require such verification would significantly hamper execution quality by slowing down the execution process. There are other ways to guard against the risk that securities sold short will not be available for borrowing or that customers will provide inaccurate information. For example, in the prime brokerage context, SIA would be receptive to a requirement that executing brokers and customers include whether a trade has been designated as a long sale or a short sale in the trade details provided to the prime broker to enable prime brokers to contact executing brokers in the event there is not a match in all the trade details received by prime brokers from customers and executing brokers.⁵⁶ This could be accomplished by including a field in the Omgeo TradeSuite confirm (formerly known as the DTC ID confirm) for whether the sale is long or short. If the information does not match, the prime broker could contact the executing broker and they could take reasonable steps if they observe a pattern or practice of inconsistent short sale designations.⁵⁷

B. Safeguards Against Extended Fails

Although SIA shares the Commission's concerns about the problems that can be caused by naked short sales and extended settlement failures, Regulation SHO's delivery requirements, as currently drafted, would be difficult to implement and would impose harsh penalties on investors, particularly small investors. Current regulatory safeguards,⁵⁸ together with internal firm policies and procedures to avoid settlement failures, are functioning effectively in most circumstances.

SIA agrees with the Commission's stated goal that Regulation SHO's delivery requirements should be targeted at securities where there is evidence of significant settlement failures. SIA believes that the levels set forth in NASD Rule 11830 represent a good starting

⁵⁶ Consistent with previous Commission guidance, the ultimate obligation for compliance with the locate requirement would remain with the executing broker, not the prime broker. *See* Prime Broker Committee, SEC No-Action Letter, 1994 SEC No-Act. LEXIS 466 (Jan. 25, 1994).

⁵⁷ To avoid any disruption of the settlement process, a sale should continue to settle in the ordinary course despite a failure to match.

⁵⁸ Such regulatory measures, including NASD Rule 11830 and NASD Rule 3210 as well as SEC Rules 15c3-3 and 15c3-1, impose requirements on firms when there are settlement fails.

point for identifying those securities. SIA urges the Commission to work with the broker-dealer industry and the clearing agencies to determine appropriate criteria for each market (*e.g.*, exchange-listed securities) based on the characteristics of that market.

With respect to the design of the proposed delivery requirements, SIA suggests the following changes. First, any consequences for extended settlement failures in securities that exceed the specified threshold should be triggered ten days after settlement date, as is the case under the NASD's mandatory buy-in rule (Rule 11830). The Commission's proposal to impose penalties only two days after settlement date would capture many more instances of ordinary course settlement delays (due to errors, changes in availability, *etc.*) than of naked short selling. Moreover, because most settlement failures are not apparent until after the settlement date, more than two days are needed to enable participants to identify and cure "innocent" settlement failures.

Second, instead of imposing a 90-day freeze for extended settlement failures in securities that exceed the specified threshold, the Commission should require the broker-dealer that carries the account to buy in the position. A 90-day freeze is an unduly punitive measure, particularly considering that the short seller's failure to deliver may be caused by that person's failure to receive. The proposed 90-day freeze also could be easily circumvented by most institutional investors who can simply take their short sales to another executing broker. Most importantly, a 90-day freeze would be difficult—if not impossible—to implement for the simple reason that a trading freeze cannot be allocated across accounts. For example, assume that a firm's net delivery obligation is 10,000 shares, resulting from three customers who sold short 10,000 shares each and other customers who purchased a total of 20,000 shares. Further assume that the firm fails to deliver the 10,000 shares for longer than ten days (assuming the proposal is revised as described above). Because NSCC's continuous net settlement system nets all buys and sells within a particular firm, the broker-dealer cannot determine which customer's transaction gave rise to the fail. While it is possible to allocate the costs of a buy-in among multiple short sellers, a trading freeze, however, cannot be allocated. SIA believes that a mandatory buy-in rule would be a better means to create additional discipline on naked short selling and should, in conjunction with existing regulatory requirements,⁵⁹ provide firms with an incentive to eliminate fails.

Third, for similar reasons, SIA believes that the imposition of financial penalties, *e.g.*, clearing agencies withholding the benefit of any mark-to-market amounts under proposed Rule 203(b)(3)(ii)(B), would be unnecessary and unduly harsh. Both existing rules as well as some of the proposed rules effectively address extended fails and create the incentives for market participants to increase their efforts to reduce extended fails.

In determining the appropriate rules to address extended fails, we would make two further recommendations. First, the SEC and SROs should work together with the current SIA industry effort through the SIA Securities Operations Division Buy-In Rules Subcommittee. This subcommittee has prepared rule changes to current buy-in rules to promote more effective and efficient fail management, as well as address the appropriate allocation of the risks and costs

⁵⁹ Among other things, extended fails may have negative consequences under the Commission's net capital and customer protection rules.

of fails among market participants. We request that the SEC and the SROs actively work with this subcommittee's on-going review this year. Second, the SEC and the SROs may also want to consider whether to utilize their existing authority to determine to what extent non-bona fide market making trading activities by market makers does or does not contribute to extended fails. We would suggest that the regulators work jointly with the securities industry in reviewing any findings or recommendations of the SEC and the SROs.

C. Long Sale Delivery Requirements

Rule 203(a) of Regulation SHO would retain the existing long sale delivery requirements in Rule 10a-2, which generally prohibits a broker-dealer from delivering borrowed shares to settle a sale if the broker-dealer knows or has "reasonable grounds to believe" that the sale was marked long. SIA believes that this anachronistic rule is no longer needed because the order marking, locate, and delivery provisions of Regulation SHO would alleviate the problems that Rule 10a-2 was designed to address. In addition, retaining Rule 10a-2 would seem to be inconsistent with the Commission's emphasis on reducing fails.

D. General Issues

1. Pre-Emption of SRO Locate and Delivery Requirements

SIA urges the Commission to clarify that Regulation SHO would pre-empt SRO locate and delivery requirements. Regulation SHO's locate and delivery requirements would apply to all equity securities regardless of the market where they are traded. We believe that adoption of uniform rules would improve market efficiency.

In contrast, the current regulatory regime is plagued with inconsistencies. For example, both NYSE Rule 440C.10, and Interpretation /01 thereunder, and NASD Rule 3370 require that a broker-dealer accepting a short sale order take steps to obtain reasonable assurances that securities will be available for delivery. However, the scope of each locate rule is different—*e.g.*, the NASD rule expressly exempts proprietary short sales that result in fully arbitrated or hedged positions, whereas the NYSE interpretation does not contain a comparable exemption.

The Proposing Release indicates that Regulation SHO's locate and delivery requirements are intended to further the goals of "regulatory simplification and avoidance of regulatory arbitrage."⁶⁰ SIA supports these goals. To the extent that the SROs have inconsistent rules, or differing interpretations of similar rules, pre-empting those requirements would help to achieve these goals and would reduce compliance, training, and other costs imposed on market participants.

⁶⁰ Proposing Release at 62,976.

2. Application of Locate and Delivery Requirements to Cross-Border Transactions

The Proposing Release does not address the extent to which the proposed locate and delivery requirements may apply to cross-border transactions. SIA urges the Commission to clarify that Rule 203's requirements only apply to trades that are settled in the United States. The Commission should not try to regulate the settlement processes and mechanisms in foreign jurisdictions. Under such an approach, a U.S. broker-dealer trading a foreign security in the home market for such security could be subject to inconsistent regulations. Firms also could face significant operational hurdles if the local clearance and settlement system differs materially from the U.S. system. For these reasons, broad application of U.S. locate and delivery requirements to transactions settled abroad would put U.S. broker-dealers at a significant competitive disadvantage when competing with foreign financial institutions and not further the goals of efficient markets or investor protection.

IV. Determining a Seller's Net Position

SIA commends the Commission's efforts to modernize the definition of a "short sale" in proposed Rule 200 by replacing Rule 3b-3, incorporating the current block positioner exception from Rule 10a-1, and codifying existing interpretations related to security futures products and the unwinding of certain index arbitrage positions. SIA believes, however, that the proposed definition would benefit from additional refinement.

A. Unconditional Contract Requirements

Under current Rule 3b-3, a person owns a security if the person has "purchased, or has entered into an unconditional contract, binding on both parties thereto, to purchase it but has not yet received it." The Commission proposes incorporating this standard in Rule 200(b)(2), but would require, in addition, that an unconditional contract specify the price and amount of securities to be obtained for a person to claim ownership of a security.

SIA agrees with the commenters that opposed requiring a fixed price when the Commission first proposed this approach in 1992.⁶¹ There is no evidence to suggest that objectively determinable prices and amounts that are not fixed but are agreed upon undermine the unconditional nature of such an agreement. A fixed price requirement would significantly hamper market liquidity by hindering or preventing transactions at a price to be determined in the future based on objective measures.

For example, a broker-dealer that wishes to facilitate a customer sell order and guarantee a closing price for a block of securities would be unable to claim ownership of the block under Rule 200(b)(2) prior to the close. If the broker-dealer wishes to sell securities during the course of the day to hedge this risk, the broker-dealer's sales would necessarily be short sales under the proposal (absent an offsetting long position). As another example and as noted above, a broker-

⁶¹ See Exchange Act Release No. 30,772 (June 3, 1992) 57 Fed. Reg. 24,415, 24,416 (June 9, 1992).

dealer facilitating a customer VWAP order will generally sell securities during the course of the day to hedge risk, but such broker-dealer will not have an incentive to depress the stock price. Given the increased cost of hedging market risk in both examples and absent a more general customer facilitation exception (as discussed in the following section), a broker-dealer in both cases may be less likely to engage in, or may charge more for, facilitation of customer orders to be filled at an indeterminate price. Moreover, the fixed price requirement may effectively prohibit U.S. institutions from offering certain products, such as variable forwards. In sum, the proposed requirement that an unconditional contract specify the price and amount of securities to be obtained would result in less liquidity at greater cost.

More generally, SIA believes that the Commission should address abusive trading practices through the anti-fraud and anti-manipulation provisions of the federal securities laws rather than through definitional provisions in current Rule 3b-3(b) or proposed Rule 200(b)(2). In particular, the relevant inquiry should be whether a strategy to create an artificial “long” position in order to circumvent the tick test or bid test has the effects that short sale regulation is intended to prevent.

B. Hedging Exception

While the Proposing Release states that a hedging exception is not necessary in the Commission’s view because the proposed bid test and pilot would provide market participants with additional flexibility in effecting short sales in order to hedge long exposure, the Commission seeks comment on this issue.⁶² SIA proposes adding a hedging exception to Regulation SHO and, on this point, SIA’s Derivative Products Committee has formed a working group to address this subject in detail and expects to submit a comment letter shortly.

C. Real-Time Position Determinations are Not Feasible

The Proposing Release asks whether, in light of the advances in technology since imposition of an at-least daily netting obligation in 1990,⁶³ it is possible for firms to determine their aggregate position in all proprietary accounts contemporaneously throughout the day. SIA believes that this will create substantial technical difficulties for many broker-dealers, particularly those who have not implemented aggregation units in which net positions are already continuously determined. As acknowledged in the Proposing Release, broker-dealers have long represented that netting on a daily basis is a costly, burdensome and potentially counterproductive undertaking for large, multi-service firms.⁶⁴ Nevertheless, firms have implemented electronic recordkeeping systems designed to meet this daily netting obligation. SIA believes, however, that requiring firms to modify their respective systems to net positions in real-time would be significantly expensive with little or no attendant benefit to the investing public.

⁶² Proposing Release at 62,995.

⁶³ See Exchange Act Release No. 27,938 (Apr. 23, 1990).

⁶⁴ Proposing Release at 62,993.

V. Order Marking

Proposed Rule 201 would combine the existing order marking requirements in Rule 10a-1 and in SRO rules. In contrast to Rule 10a-1, proposed Rule 201 would differentiate “short exempt” orders from orders marked “long” or “short.” An order could only be marked “long” when the seller owns the security being sold and the security either is in the physical possession or control of the broker-dealer or will be prior to the settlement of the transaction. A sell order would be required to be marked “short exempt” if it were a short sale effected pursuant to an exception in Rule 201. In brief, some orders currently marked “long” and many currently marked “short” would have to be marked “short exempt” under Regulation SHO.

SIA asks that the Commission consider whether the anticipated benefits of marking orders “short exempt” outweigh the costs of firms modifying their systems, revising compliance materials, and training registered personnel to appropriately mark orders “short exempt” pursuant to the exceptions in Regulation SHO. The added surveillance benefit noted by the Commission in the Proposing Release is not easily quantified and may not clearly outweigh the increased burden. Moreover, the analysis to be made when marking an order is more properly made by a trading desk than a salesperson. Thus, the SIA believes that current order-marking practices and requirements should be maintained.

VI. Elimination of Shelf Offering Exception from Rule 105 of Regulation M

The Commission has proposed to eliminate the shelf offering exception from Rule 105 of Regulation M. In explaining the reasons for this proposal, the Proposing Release notes that sales by an individual during the five days following the announcement of a shelf takedown but before its pricing have the same manipulative potential and effect on the offering price that the rule is designed to prevent.⁶⁵

SIA would like to point out that shelf takedowns generally are not conducted as multi-day “marketed deals” as described in the Proposing Release. In many cases, a shelf takedown will occur on an “overnight” or “bought deal” basis, with the offering commencing after the close of the regular trading session and most or all of the securities being placed before the open of trading on the next day. The elimination of the shelf offering exception under Rule 105 would mean that investors who engaged in short sales during the five business days prior to the takedown would be unable to purchase securities in the offering even though they and, more generally, the market did not have any knowledge of the impending shelf takedown at the time of effecting such short sales. SIA believes that short sales by persons without knowledge of a shelf offering are not the type of activity that Rule 105 is designed to prevent.

Thus, SIA recommends that the Commission retain the shelf offering exception to Rule 105 but limit it to “overnight” or “bought deal” offerings. These could be defined as shelf takedowns for which no “red herring” or preliminary prospectus is distributed to investors.

⁶⁵ Proposing Release at 62,999.

VII. Married Put Interpretation

While SIA recognizes the Commission's legitimate concerns regarding manipulative uses of married put transactions, SIA believes that the Commission's recent Married Put Release is not the most effective means to address these concerns, and may have raised more questions than it answered. Indeed, SIA understands that many firms may have raised questions with the staff of the Commission already about the intended scope of the interpretation. The Married Put Release suggests that problematic married put transactions are usually evidenced by some or all of six key factors or "a variation of them."⁶⁶ Although SIA agrees that these factors may in certain cases establish the appearance of a long position for the purpose of circumventing the Commission's rules without sufficient economic substance, various combinations of these same factors or variations of them also may be present with legitimate trading strategies, such as forward conversions. The Married Put Release created substantial uncertainty by indicating that not all of these factors need to be present and that "variations thereof" may suffice.⁶⁷

Such misunderstandings might well have been avoided if the conditions of the Married Put Release had been included in the Proposing Release for public comment, rather than published in an interpretive release with no opportunity for public comment. SIA urges the Commission to replace the Married Put Release with proposed rule amendments that codify an objective test for identifying abusive married puts (and offer an opportunity for public comment).

* * *

We appreciate this opportunity to express our views on this important proposal. Again, SIA commends the Commission for comprehensively reviewing existing short sale regulation. SIA shares the Commission's goal of modernizing and enhancing the existing regulatory

⁶⁶ The six factors detailed in the Married Put Release are: (i) the purchase of an at- or in-the-money non-standardized put option with a brief (1 to 5 day) expiration period; (ii) the contemporaneous purchase of an equivalent number of shares of the same security; (iii) the contemporaneous sale of the stock acquired with a married put, in essence divorcing the stock position from the put option; (iv) the repeated use of a "facilitator" that sells both the puts and the "long" position (often by selling the stock short to the counterparty); (v) the "netting out" of the transaction between the facilitator and the counterparty, often at the end of the day the married put was purchased; and (vi) the payment of a standardized fee, not calculated in accordance with a standard options pricing model, to the facilitator for the transaction.

⁶⁷ For example, SIA believes that the Married Put Release does not make clear whether the guidance contained therein applies to listed options as well as OTC options.

framework while protecting investors and promoting efficient markets. SIA hopes that the suggestions in this letter are helpful and offers to work with the Commission going forward in further refining U.S. short sale regulation. If the Commission or its staff have any questions, please do not hesitate to contact the undersigned at 202-216-2000, Amal Aly, Vice President and Associate General Counsel, at 212-608-1500, or Ann Vlcek, Vice President and Associate General Counsel, at 202-216-2000.

Sincerely,

George R. Kramer
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