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Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20459-0609



Re: File No. S7-23-03, Proposed Rule: Short Sales

Dear Mr. Katz:

National Securities Clearing Corporation ("NSCC") appreciates the opportunity to comment on the proposal by the Securities and Exchange Commission (the "Commission") to adopt Regulation SHO under the Securities Exchange Act of 1934 (the "Exchange Act").¹ NSCC is a clearing agency registered with the Commission under Section 17A of the Exchange Act. NSCC provides centralized clearance, settlement and information services for a substantial majority of U.S. trades between broker-dealers in equity securities, corporate and municipal bonds, exchange-traded funds and unit investment trust shares.

In performing these services, NSCC facilitates netting and settlement of participants' open securities positions through the Continuous Net Settlement ("CNS") System. The CNS System is an automated book-entry accounting system that centralizes the settlement of compared securities transactions and maintains a flow of securities and money balances. The CNS System clears transactions in equity securities, corporate bonds, unit investment trust shares and depository-eligible municipal bonds.

I. Introductory Remarks and Summary of Comments.

NSCC commends the Commission for its effort to address issues related to the settlement of short sales of equity securities. Rule 203 of proposed Regulation SHO (the "Proposed Rule") provides in part as follows:

(b) Short Sales.

(3) For any security where there are fails to deliver at a clearing agency registered with the Commission of 10,000 shares or more (an "aggregate fail-to-deliver position"), and that is equal to at least one-half of one percent of the issue's

¹ Exchange Act Release No. 48709 (October 28, 2003), 68 Fed. Reg. 62972 (November 6, 2003) (the "Proposing Release").

total shares outstanding (the “proposed percentage threshold”), if a broker or dealer executes a short sale for its own account or the account of another person, and if for any reason whatever securities have not been delivered within two days after the settlement date (a “qualifying fail-to-deliver position”):

(i) For a period of ninety calendar days the broker or dealer shall not execute a short sale in such security for his own account or the account of the person for whose account the failure to deliver occurred unless the broker or dealer or the person for whose account the short sale is executed has borrowed the security, or entered into a bona fide arrangement to borrow the security, and will deliver the security on the date delivery is due; and

(ii) The rules of a clearing agency registered pursuant to Section 17A of the Exchange Act shall include the following provisions:

(A) A broker or dealer failing to deliver securities as specified in subparagraph (3) above shall be referred to the National Association of Securities Dealers (the “NASD”) and the Examining Authority² for such broker or dealer for appropriate action; and

(B) The registered clearing agency shall withhold a benefit equal to any mark to market amounts or payments (a “mark”) that otherwise would be made to the participant failing to deliver, and assess appropriate charges.³

NSCC’s comments on the Proposed Rule are set forth in Part II of this letter as follows:

- In Part II.A, NSCC describes the type of information on aggregate fail-to-deliver positions that it has been providing to the NASD and has recently begun furnishing to the Commission, the NASD,

² See 17 C.F.R. § 240.15c3-1(c)(12).

³ The Commission has previously noted that, unlike with other self-regulatory organizations, the Commission does not have the authority under Section 19(c) of the Exchange Act to abrogate, add to or delete from the rules of a particular clearing agency. NSCC wants to assure the Commission, however, that its efforts to comply with Regulation SHO as finally adopted would be made in the same cooperative spirit that has existed between the Commission and NSCC dating back to NSCC’s registration as a clearing agency.

the New York Stock Exchange (the “NYSE”) and the American Stock Exchange (the “Amex”).

- In Part II.B, NSCC explains certain practical considerations that would prevent NSCC from determining under the existing CNS System whether any mark that would be paid to a broker-dealer would be a benefit and received in connection with a qualifying fail-to-deliver position.
- In Part II.C, NSCC (i) responds to certain public comments on the Proposing Release that appear to be based on a misunderstanding of the NSCC stock borrow program (the “Stock Borrow Program”) and (ii) summarizes the measures currently available under certain NSCC rules, procedures and processes that may be invoked to address certain potential negative consequences of its participants’ fail-to deliver positions.

II. Comments on the Proposed Rule.

A. Analysis of Current NSCC Information Collection Efforts Regarding Aggregate Fail-to-Deliver Positions in Certain Securities.

NSCC understands that the Proposed Rule would require a registered clearing agency to collect information regarding whether any security has an aggregate fail-to-deliver position exceeding the proposed percentage threshold. In this regard, the Proposing Release states that:

[NSCC] currently tracks this information on fails to deliver and provides it to Nasdaq for purposes of administering NASD Rule 11830. Thus, we do not believe that the threshold proposed here would impose unduly burdensome data collection requirements.⁴

⁴ See Proposing Release, 68 Fed. Reg. at 62977 n.50.

NASD Rule 11830 states that:

(a) A contract involving a short sale in Nasdaq securities described in paragraph (b) hereof, for the account of a customer or for a member’s own account, which has not resulted in delivery by the broker/dealer representing the seller within 10 business days after the normal settlement date, must be closed by the broker/dealer representing the seller by purchasing for cash or guaranteed delivery securities of like kind and quantity.

(b) This requirement shall apply to Nasdaq securities, as published by the Association, which have clearing short position[s] of 10,000 shares or more and that are equal to at least one-half (1/2) of one percent of the issue’s total shares outstanding.

(continued...)

NSCC notes, however, that it currently does not track all of the information that the NASD may require to administer NASD Rule 11830.

At present, NSCC analyzes daily each over-the-counter security (*i.e.*, individual CUSIP) in its system as of the close of delivery processing for the day and determines whether any such security has an aggregate fail-to-deliver position of 10,000 or more shares and, if so, NSCC reports to the NASD all participants with a position in such security. NSCC does not take the added step of determining for purposes of NASD Rule 11830 whether the aggregate fail-to-deliver position in such a Nasdaq security equals at least one-half of one percent of the total outstanding shares of that security, as contemplated in the Proposed Rule,⁵ in part since NSCC does not have the information regarding total outstanding shares needed for that calculation. The calculation of one half of one percent of outstanding shares is currently performed by the NASD.⁶

In an expansion of these reporting procedures, NSCC has commenced furnishing daily to each of the Commission, the NASD, the NYSE and the Amex a list identifying each equity security in which there is an aggregate fail-to-deliver position at NSCC of 10,000 or more shares.⁷ Each such list identifies any NSCC participant with a fail-to-deliver position at NSCC in one or more of the identified securities. NSCC believes that this expanded information-sharing arrangement provides the Commission, the NASD, the NYSE and the Amex with important information regarding the fail-to-deliver positions of NSCC's participants in every security for which the aggregate fail-to-deliver position equals or exceeds 10,000 shares.

It is our understanding that, currently, firms are notified by the NASD on a daily basis of securities that are subject to Rule 11830 restrictions. NSCC expects that other self-regulatory organizations would similarly notify their participants of affected securities and that there is no expectation that NSCC would be involved in this aspect of securities monitoring.

(...continued)

(c) This mandatory close-out requirement shall not apply to bona fide market making transactions and transactions that result in fully hedged or arbitrated positions.

⁵ See Proposing Release, 68 Fed. Reg. at 62977 n.50.

⁶ NSCC believes that such calculation for purposes of the Proposed Rule should be performed by the appropriate examining authority to avoid imposing a new and more burdensome data collection and calculation requirement on NSCC.

⁷ NSCC estimates that its costs for expansion of this information-sharing process were approximately \$16,800. NSCC estimates that operating costs to provide information on all fail-to-deliver positions in accordance with this expansion will initially be about \$115 per month.

B. Practical Considerations Regarding NSCC's Ability to Comply with Certain Requirements of the Proposed Rule.

NSCC understands that the Proposed Rule would require a registered clearing agency to withhold a benefit equal to any mark that would be paid to a participant with respect to a qualifying fail-to-deliver position and assess appropriate charges.⁸ As a practical matter, however, NSCC believes that the manner in which the CNS System calculates each participant's net position in a security would preclude any efforts by NSCC to determine systemically whether any mark paid to a participant would be (i) a benefit and (ii) received in connection with a qualifying fail-to-deliver position. The CNS System does not determine, and therefore NSCC cannot know, whether an obligation to deliver securities results from any short sale transaction.

In the CNS System, the clearing fail-to-deliver position of a participant in a security reflects fails to deliver arising from long sale and short sale transactions in such security, and also any netting against any receive obligation of such participant.⁹ For purposes of settling a participant's open securities transactions on a particular day, the CNS System nets all open positions of the participant, together with such participant's positions due to settle for the first time that day, down to a single value. In performing this calculation, the CNS System does not retain information regarding the individual transactions that the participant may have executed in a particular security (e.g., whether a transaction was a sale from a long position or a short sale).

Even if the CNS System were able to track sale transactions through to settlement, NSCC cannot track a mark to an individual CUSIP or transaction. In the CNS System, for circumstances in which the market price of the security underlying the participant's net short position has decreased to an amount less than the system price by the end of a trading day, such participant would receive a mark equal to the difference between the system price and the market price for that day.¹⁰

⁸ See Proposing Release, 68 Fed. Reg. at 63009.

⁹ The Commission has previously acknowledged, in connection with approving NASD Rule 11830 (then Section 7 of the NASD Uniform Practice Code), that open securities positions at registered clearing agencies may result from a variety of factors other than short sale transactions. See Exchange Act Release No. 32632 (July 14, 1993), 58 Fed. Reg. 39072, 39073 (July 21, 1993) (“[T]he NASD stated that there are many reasons why certain securities have unsettled trades at clearing corporations for lengthy periods, which may be completely unrelated to short selling . . .); *id.* at 39073 n.25 (“The NASD undertook an analysis of the factors affecting fails-to-deliver to the NSCC and the fluctuations in such fails to deliver. . . . The NASD’s analysis . . . suggested that the existence of fails-to-deliver at NSCC confirms little or nothing about short sales, unless the fail-to-deliver condition is large and persistent.”); NASD Notice to Members 93-53 at n.5 and accompanying text (July 14, 1993) (describing the same concept).

¹⁰ In this example, the participant would not receive the full system price of its short position as a mark unless the market price of the underlying security fell to zero by the end of a trading day.

Conversely, for circumstances in which the market price of the security underlying the participant's net short position has increased to an amount greater than the system price by the end of a trading day, such participant would be required to pay a mark equal to the difference between the market price and the system price. The CNS System therefore does not pay marks based on a particular transaction by a participant.

Even if the CNS System could track sale transactions through to settlement, it would be impossible for NSCC to determine if a mark was a benefit. For example, some marks paid by a participant could be paid back to such participant when the value of the netted open obligation moves in the opposite direction from the previous day's value.

Under the existing CNS System, therefore, NSCC would be unable to enforce a provision that would mandate withholding from a participant a benefit equal to a mark that would be paid on a qualifying fail-to-deliver position.

C. Additional Comments Related to the Proposing Release.

1. Response to Certain Public Comments Regarding the NSCC Stock Borrow Program.

NSCC is aware that the Commission has received comments on the Proposing Release that suggest that the Stock Borrow Program has the effect of increasing fails to deliver on short sale transactions by lending more shares of a security than are actually available from NSCC's participants.¹¹

NSCC wishes to assure the Commission and the investing public that the Stock Borrow Program does not lend more shares than participants designate in their accounts at The Depository Trust Company ("DTC") as available for borrowing by NSCC. If a participant does not have the requisite number of securities on deposit in its DTC account or has not designated them as available for borrowing by NSCC, NSCC does not borrow those securities.

Participants that are active in the Stock Borrow Program will notify NSCC each day of the securities that they have on deposit at DTC that NSCC may borrow. NSCC only borrows securities that are in fact in the participant's DTC account and ready for borrowing (i.e., unencumbered by other claims). NSCC borrows securities pursuant to the Stock Borrow Program only for the purpose of attempting to cover fails to deliver in the CNS System. After NSCC processes its regular deliveries overnight, it will satisfy any high-priority delivery obligations with

¹¹ See, e.g., letter from Ralph A. Lambiase, President, North American Securities Administrators Association, Inc., to Jonathan Katz, Secretary, Securities and Exchange Commission (January 5, 2004) ("[T]he Commission should explicitly prohibit [The Depository Trust Company] from lending more shares of a security than it actually holds.").

securities borrowed from its participants. As a result of the Stock Borrow Program, customers of NSCC participants that have purchased securities from a counterparty that sold such securities short have an increased chance of receiving those securities on the settlement date for the transaction and therefore having the ability to vote the stock.¹²

Accordingly, NSCC requests that the Commission clarify in the release accompanying the final version of the Proposed Rule that the Stock Borrow Program does not lend more securities than NSCC's participants designate as available (and that are in fact available) for borrowing from their DTC accounts.

2. Certain Measures for Addressing Potential Consequences Associated with Fail-to-Deliver Positions in the CNS System.

As the Commission considers the Proposed Rule, NSCC notes that under certain of its existing rules, procedures and related processes, NSCC participants have the ability to take remedial action in connection with fail to receive positions. A participant that has a short position may be subject to a "buy-in" in order to cover that short position.¹³ Under NSCC's rules and procedures, where a participant fails to deliver all of the securities at the date and time specified by NSCC, the participant to whom the securities were not timely delivered may cause those securities to be bought-in.

A participant with a long position at the end of any day may send to NSCC a notice that states an amount of securities not exceeding such long position that the participant wants to buy-in (the "originating participant"). If the originating participant's buy-in position remains unfilled at the end of the day after it submitted its buy-in notice, NSCC will issue "retransmittal notices" to a sufficient number of participants with short positions in the security to be bought-in ("subject participants"). Retransmittal notices are issued in an aggregate quantity at least equal to the buy-in position of the originating participant. If there are several subject participants with short positions of the same age in the security to be bought-in, NSCC will issue a retransmittal notice to each such subject participant even if the total of their short positions exceeds the buy-in position.

A subject participant's buy-in liability may be satisfied by the actual settlement of its short position up to the end of the second day after the buy-in notice was submitted to NSCC. If a buy-in position is not satisfied at such time, the originating participant may instruct NSCC to buy-in securities by submitting a buy-in order to NSCC.

¹² See generally Proposing Release, 68 Fed. Reg. at 62975 (explaining that fails to deliver on short sale transactions adversely affect certain rights of the buyer, including the right to vote).

¹³ See, e.g., NSCC Rule 10-1; NSCC Procedure VII; NSCC Procedure X.

Subject participants that have not satisfied retransmittal notices will assume liability for the loss, if any, which occurs as a result of the buy-in order. The subject participants with the oldest short positions will be the first held liable for an executed buy-in order. NSCC will execute the buy-in order and the amount of securities bought-in will be prorated among the subject participants.

Once NSCC has executed a buy-in order, the amount of securities bought-in will be removed from the long position of the originating participant and the related contract money will be credited to such participant's account. The short position of each subject participant will be reduced by the portion of the amount bought-in allocated to it, and the related portion of the contract money will be debited to its account.

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NSCC appreciates the opportunity to comment on the Proposing Release.

Sincerely yours,

NATIONAL SECURITIES CLEARING
CORPORATION

A handwritten signature in black ink, appearing to read 'Donald F. Donahue', written over a horizontal line.

Donald F. Donahue

President