



RBC Capital Markets Corporation
One Liberty Plaza
165 Broadway
New York, NY 10006-1404

Richard Chase
Managing Director & General Counsel

Telephone: (212) 858-7111
Fax: (212) 858-7455

June 19, 2009

Via email: rule-comments@sec.gov
Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

**Re: Release No. 34-59748; File No. S7-08-09;
Amendments to Regulation SHO**

Dear Ms. Murphy:

The Capital Markets platform (see below) of RBC Capital Markets Corporation ("RBCCMC") submits below its comments to Securities Exchange Act Release Number 34-59748 (Apr. 10, 2009) (the "Release")¹ regarding proposed amendments to Regulation SHO. We appreciate the opportunity to comment on the Securities and Exchange Commission's (the "SEC" or "Commission") proposals.

RBC Capital Markets Corporation

RBCCMC is a full-service broker-dealer with approximately 7,000 employees working across its Wealth Management and Capital Markets platforms. The wealth management business provides investment services to retail customers from 261 branch office locations. The platform also includes a fully disclosed correspondent clearing business. The Capital Markets platform, among other things, engages in fixed-income and equity sales and trading, investment banking and derivatives activities. The comments below are provided on behalf of the Capital Markets platform.

¹The Commission proposes the reinstatement of price restrictions in connection with short sales of NMS securities. Five alternative restrictions are presented in the Release: (i) a market-wide price test based on the national best bid (similar to the former NASD "bid test" - the "modified uptick rule"); (ii) a market-wide price test based on last sale price (similar to former Securities Exchange Act Rule 10a-1 - the "uptick rule"); (iii) a circuit breaker triggering a halt on short sales of a particular security (the "circuit breaker halt rule"); (iv) a circuit breaker triggering a bid test restriction on short sales of a particular security (the "circuit breaker modified uptick rule"); and (v) a circuit breaker triggering a price test on short sales of a particular security (the "circuit breaker uptick rule").

Introduction

RBCCMC is opposed to the restoration of *any* price restriction in connection with the short sale of securities. Re-introduction of a short sale price restriction has been proposed as a means to prevent short squeezes or other abusive or manipulative short selling, as well as to restore investor confidence in the integrity of the market. As noted time and again in the Release, however, there is no empirical evidence to support the proposition that a short sale price restriction will (i) prevent potentially abusive or manipulative short selling from being used as a tool for driving down the market, or to accelerate a declining market, (ii) help restore "investor confidence" and "market stability" or (iii) not harm an already fragile market by shrinking liquidity and impeding price discovery. Given the lack of data that either supports or refutes the effectiveness of any short sale price restriction, it is premature for the Commission to require market participants to expend the substantial time and resources that would be necessary to implement any of the proposed alternatives.

Notwithstanding, if the Commission determines that some form of price restriction is necessary, we advocate that the "circuit breaker modified uptick rule" (revised as discussed below) be adopted. This alternative would have the least impact on the market and, therefore, the smallest risk of adversely impacting market liquidity and/or price discovery. We further advocate, however, that any restriction be implemented on a pilot program basis to afford the Commission and market participants the opportunity to examine and consider collected data, and reach a reasoned long-term solution.

Lack of Empirical Data, Current Market Conditions, and Investor Confidence

The restoration of any short sale price test restriction at this time, without the benefit of a thorough considered analysis, would be premature. As noted in the Release, short sale price restrictions were eliminated by the Commission in July 2007, less than two years ago.² The elimination of the restrictions was the culmination of a "careful, deliberative" process that involved the collection and analysis of data over a seven-year period from 1999 through 2006. Indeed, we are unaware of any regulatory action taken by the Commission that was preceded by such a thorough in-depth analysis. The Release asserts, without any quantitative analysis, that recent "extreme market conditions," market volatility (including steep declines in the price of some securities) and the resulting "loss of investor confidence in our markets" justify the reinstatement of price restrictions.³ The SEC admits, however, that they "are not aware of specific empirical evidence that the elimination of short sale price tests has contributed to the increased volatility in U.S. markets."⁴ Indeed, the SEC's Office of Economic Analysis ("OEA") examined the extent to which short selling appeared to drive prices downward during the first weeks of September 2008 and whether there exists an association between measures of short selling activity and stock returns. The OEA found, among other things, that its "results are inconsistent with the notion that, on a regular basis, episodes of extreme

² See SEC Release 34-55970 (June 28, 2007).

³ Release at 17.

⁴ *Id.*

negative returns are the result of short selling activity. On average, short sale volume as a fraction of total volume is higher for periods of positive returns than for periods of negative returns.”⁵ The OEA also found that short sales put less pressure on prices than did long sales during periods of extreme negative returns.⁶

Reinstatement of a short sale price restriction would inherently interfere with the operation of a free and open market and thereby impinge on some legitimate short selling, and the benefits that result from such activity: market efficiency, price discovery, increased liquidity and protection against upward price manipulation. Given the admitted absence of any clear market benefit, and faced with recognized adverse consequences, taking action at this time, in the current fragile market environment, to restore any form of restriction without a thorough analysis would be ill advised.

Furthermore, we question whether there is any connection among extreme market conditions, short sales and the deterioration of investor confidence. It is difficult to measure investor confidence, let alone investor confidence as it relates to short sale activity. The Commission states that “as market conditions continued to worsen, investor confidence has eroded, and the Commission received requests from commenters to consider imposing restrictions with respect to short selling, in the belief that such action would help restore investor confidence.”⁷ Isolated requests by some issuers and investors for restoration of a price restriction hardly amount to evidence that investor confidence has been impaired by removal of a short sale price test. Nor is there any means to determine whether or how the restoration of short sale price restrictions would help restore investor confidence. Indeed, as market conditions have recently stabilized a strong argument can be made that investor confidence has been restored.⁸ We seriously question the wisdom of adopting a permanent rule to restrict a free and unfettered market based on subjective perceptions of transitory investor sentiment. Given the recent lack of volatility in the marketplace, we believe that the urgency of imposing a price restriction on short sales of securities is not as great as the need to conduct the appropriate due diligence to arrive at a carefully deliberated long-term solution.

Sufficiency of Current Short Sale Regulation

We believe the SEC already has the tools at its disposal to address abusive and manipulative short selling activity and that, accordingly, price restrictions are not necessary. Current short sale regulation, in addition to the anti-fraud and anti-

⁵ SEC Office of Economic Analysis, Memorandum Regarding Analysis of Short Selling Activity During the First Weeks of September 2008 1, ¶ 3 (Dec. 16, 2008), *available at* <http://www.sec.gov/comments/s7-08-09/s70809-369.pdf>.

⁶ *Id.* at 2.

⁷ Release at 5.

⁸ In the May 2009 Consumer Confidence Survey, published by The Conference Board, it was reported that, “The Conference Board Consumer Confidence Index, which had improved considerably in April, posted another large gain in May. The Index now stands at 54.9 (1985 = 100), up from 40.8 in April.” The Conference Board, May 2009 Consumer Confidence Survey Press Release ¶ 1, *available at* <http://www.conference-board.org/economics/ConsumerConfidence.cfm>.

manipulation provisions of the securities laws, are sufficient to address the abuses articulated by the Commission in the Release. The requirement under Rule 204T that market participants close-out fail to deliver positions no later than the beginning of regular trading hours on the settlement day following the settlement date has dramatically reduced fail to deliver positions (and naked short selling). In fact, between September 23, 2008 and March 31, 2009, the average “daily fails to deliver shares decreased by 56.6%,” and the “average daily fails to deliver shares in threshold securities decreased by 73.5%.”⁹ In addition, through new SEC Rule 10b-21,¹⁰ the SEC has signaled to market participants the seriousness with which the SEC views abusive short sale practices.

We believe that the Commission can change the public's perception of short selling and accomplish its goal of restoring investor confidence through investor education (e.g., issuing guidance to market participants similar to its approach in connection with client commission practices)¹¹ and appropriate enforcement action against abusive short selling. This approach would spare market participants the tremendous time and expense (discussed in greater detail below) that would be required to implement any of the alternative price restrictions proposed by the Commission.

Overall Effectiveness of Short Sale Price Restrictions on Downward Price Pressure

RBCCMC believes that short sale price restrictions can inhibit downward price drifts on an intra-day basis, and even for short periods of days. We question, however, the ability of short sale price restrictions to relieve downward pressure on the price of securities over an extended period of time. Furthermore, downward price pressure can be exerted in a variety of ways that would not be prohibited under any of the Commission's current price restriction proposals. Sales of calls and purchases of puts would not be subject to the short sale price restrictions set forth under the proposed rules. Nor would short selling in security futures, which can be implemented using either single stock futures and/or futures on narrow-based stock indices.

The decimalization of the equity markets has also significantly compromised the effectiveness of price stabilizers in maintaining fair and orderly markets in a post-Regulation NMS market environment. This fact coupled with the market fragmentation in our equity markets, would make any price test solution both much less effective and extremely difficult to implement.

The Circuit Breaker Modified Uptick Rule

As stated above, in the event the Commission decides to implement a price test restriction, RBCCMC recommends the circuit breaker modified uptick rule (revised as discussed herein) over any of the other proposed alternatives. As observed in the

⁹ 17 C.F.R. § 242.204T (2008). Office of Economic Analysis, Memorandum Regarding Impact of Recent SHO Rule Changes on Fails to Deliver 3, ¶ 1- 2 (Apr. 16, 2009), available at <http://www.sec.gov/comments/s7-30-08/s73008-121.pdf>.

¹⁰ 17 C.F.R. 10b-21 (2008).

¹¹ See SEC Release 34-54165 (July 18, 2006).

Release, it is a "narrowly tailored response to extraordinary circumstances."¹² Relatively speaking, it would have the least impact on the marketplace as only those securities in fact experiencing material downward price pressures would be subject to the price test upon the triggering of the circuit breaker. By contrast, under the proposed modified uptick and uptick rules, all securities are subject to the restriction at all times during trading hours. The limited duration of the price test following the triggering of the circuit breaker (the remainder of the trading day) would focus the impact of the rule on those stocks that are potentially subject to "abusive" short selling without impinging on the market more broadly. We do believe, however, that the duration proposed under the circuit breaker alternative may be insufficient to achieve the Commission's intended purpose of halting or slowing a price decline in a security, as short sales can simply be re-entered the following day after the restriction has been lifted. Accordingly, we recommend that consideration be given to extending the restriction period through the close of trading on the trading day following the triggering of the circuit breaker.

Exceptions to the Circuit Breaker Modified Uptick Rule

The circuit breaker modified uptick rule lists eight types of transactions that are excluded from the short sale price restrictions in the event the circuit breaker is triggered.¹³ Other types of transactions, not included as exceptions to the circuit breaker modified uptick rule, are identified as possible exceptions to some of the other proposed alternative restrictions in the Release. In furtherance of the Commission's goal to create a "narrowly tailored" approach and to minimize the impact of the short sale price restrictions on legitimate market activity, we believe that several exceptions included as part of the other alternative proposals in the Release should also apply to the circuit breaker modified uptick rule (or any other short sale price restriction adopted by the Commission). These include: transactions involving errors in marking a short sale; electronic trading systems; trade throughs; facilitation of customer buy orders; market makers and options market makers engaged in bona fide market-making activities; bona fide market-making in derivatives, options and futures contract expiration; and assignment to call writers upon exercise of an option. These, and other exceptions that were *not* included as part of any of the proposed alternatives in the Release, are discussed in greater detail below.

- **Exceptions Set Forth Under Regulation NMS** – The Commission should consider implementing the exceptions set forth under Regulation NMS to any short sale price restriction. The variety of order and quotation applications of trading centers will need to take into consideration trade-throughs of protected quotations and those executed at a benchmark, such as volume weighted average price transactions (see immediately below) or stopped stock transactions. Importantly, as set forth in the Regulation NMS FAQs, a broker-dealer routing ISOs solely to facilitate its execution of a customer's long sale in compliance with

¹² Release at 186.

¹³ The eight exceptions are for transactions involving seller's delay in delivery, domestic arbitrage, international arbitrage, riskless principal transactions, transactions on a volume weighted average price basis, odd-lot transactions, and over-allotment and lay-off sales.

Rule 611, should be able to mark the ISOs as "short exempt" to allow destination trading centers to execute the orders against protected quotes without regard to price restrictions.¹⁴

- **VWAPS/TWAPS** -- We believe the Commission should incorporate the exemptions under Regulation NMS for benchmark orders encompassing broad based indices or baskets as a bona fide hedge of a structured product linked to an index or basket. We recommend that the exception apply to benchmarked orders based on an intra-day as well as a full day time frame, and urge the Commission to provide clarity in this regard.
- **Market Making Activity, Including Trading Activity Related to OTC Derivatives, Structured Notes and Listed Derivatives** -- Former NASD Rule 3350 included an exception for short sales by market makers (including options market makers) engaged in bona-fide market-making activity. A similar exception, relating to market-making activity in OTC derivatives, structured notes and listed derivatives was included by the SEC as part of the September and October 2008 short sale ban. Both of the aforementioned exceptions should be included as exceptions to any new price restriction. In addition, the Commission should include within its definition of market maker those entities that serve as counterparties to derivative transactions as a regular part of their business, as these firms serve as the functional equivalent of block positioners with respect to these derivative securities. Importantly, these entities include not only broker-dealers, who are often capital constrained to provide these services directly, but also banks and other liquidity providers. We recognize the potential for abuse in granting such a broad exception. Accordingly, we suggest that appropriate conditions be imposed (*e.g.*, that the party relying on the exception not "know" the counterparty to the derivative contract or the issuer of the convertible security).
- **Domestic Arbitrage / International Arbitrage** -- We recommend that the Commission include an exemption for domestic and international arbitrage strategies. In doing so, the rule needs to reflect the increased sophistication of the market and evolution of market trading practices. Any exemption covering arbitrage transactions should be crafted in a more flexible manner than the exemptions provided in former SEC Rule 10a-1 for such arbitrage strategies, which were limited to transactions in specially designated accounts and required the contemporaneous purchase and sale of the same or similar securities to capture a price disparity in those securities in different markets. While arbitrage strategies historically may have been so narrowly confined, there are a far broader array of legitimate arbitrage strategies that would not meet those strictures and yet should be exempted from short sale price restrictions. For example, the exemption must be sufficiently broad to accommodate convertible arbitrage strategies, especially as they relate to raising capital. In this regard, we note for

¹⁴ SEC Division of Trading and Markets, Responses to Frequently Asked Questions Concerning Rule 611 and Rule 610 of Regulation NMS, Q&A 7.05 (Apr. 4, 2008), *available at* <http://www.sec.gov/divisions/marketreg/nmsfaq610-11.htm>.

the Commission the disastrous effect the short sale ban of September and October 2008 (which did not contain such an exemption) had on convertible arbitrage strategies. For reference, we attach a letter we submitted to the Commission on September 25, 2008 detailing the effective shut-down of the convertible arbitrage market that occurred at that time. Another example relates to "delta" hedging strategies involving a long position in an instrument with an element of optionality (such as listed options, convertible debt or preferred securities, or structured notes) offset by a short position in the underlying stock. In a delta hedging strategy, the two sides of the arbitrage strategy typically are established at the same time, in sizes that result in a "delta neutral" position-in which price moves of the short stock position are offset dollar-for-dollar by price moves in the long "option" position. However, because the "delta" of the option increases or decreases as the option moves further in- or out-of-the money, the size of the underlying stock short position must be continually adjusted to keep the position delta neutral. Thus, short sales of the underlying stock may be made days, weeks or months after the initial arbitrage position was established, thereby failing to meet the contemporaneous requirement of the traditional arbitrage exemptions.

- **Options/Futures Contract expirations (Call Writer Assignment Upon Exercise of an Option)** -This exception is included in the Release in connection with the circuit breaker halt rule. The rationale for the exception-that the writer of the option has no control over the timing of assignment of an exercise notice-applies equally to all short sales regardless of the price restriction. We believe that it should be applied to the other price restriction proposals as it will facilitate fair, orderly and liquid markets.
- **Block Positioning** -- The exemption for market-making activity should clearly provide that block positioners will be allowed to sell short at the bid without violating any proposed bid test.
- **ETFs** – We believe that the Commission should include an exception relating to short sales of ETFs. Since ETFs are comprised of baskets of securities, it is unlikely that they would be subject to the abusive short selling that the Commission is seeking to address in the Release.
- **Market On Open/Market On Close Transactions**– The Commission should consider an exemption for market on open/market on close orders as there will be many more instances of market dislocations and volatility if shorts cannot be executed via MOO/MOC orders, especially for baskets and index trades. These include transactions involving short sales related to index future/option expirations that occur mainly at the market open. An exception for trading in OTC products linked to indices where the expiration of an index may cause a need to effect short sales as well as hedging transactions associated with ETFs, important for trading, creating and redeeming levered ETFs, should also be incorporated. In the event the Commission does not include an exception for MOO/MOC orders, we advocate for the inclusion of that a separate exception for index future/option expirations and ETF hedging transactions (both referenced above).

- **Program Baskets/Re-Weighting of Baskets** – The Commission should include an exception that allows short sales for the purposes of hedging a basket.
- **Index Arbitrage Trading**- We recommend that an exception be included for short sales relating to intra-day hedged basket transactions, including baskets vs. futures and baskets vs. options.
- **Exchange for Physicals** -- Short sales related to exchange for physical transactions are an important source of liquidity in the listed futures market for these products. We believe that an exception for these transactions is necessary to ensure that liquidity would not be limited.
- **Swap Hedging / OTC Option Hedging / Index Reconstitution / Index Re-weighting.** This exception would be particularly important for the Russell Index reconstitution that is done on the market close.

Costs

We believe that the Commission underestimates the time and expense that will be required for market participants to comply with any of the proposed restrictions. These costs will include expenses not only for the initial implementation of any restriction, but for its ongoing "administration" (e.g., testing, surveillance, evaluation and responding to internal and external inquiries) as well. As noted, front-end systems will need to be adjusted to provide for the new "short exempt" marking requirement. Many firms, however, have multiple front-end systems, each of which will need to be adjusted. These expenditures will be multiplied for firms with correspondent clearing operations, where each correspondent firm, in turn, can have its own front-end system. Personnel (e.g., sales, trading, compliance and back office) will need to receive training in connection with the new requirements and system changes. Market participants' front-end systems will also have to be re-worked to (i) identify where the market for a particular security is trading at any one instant and (ii) ensure proper marking of transactions. Blue sheet, OATS and OTS reporting systems will also need to be examined and adjusted to the extent FINRA, as would be expected, amends its reporting requirements to account for the "short exempt" designation. Market participants will need to insure that proper feeds to market centers are established and maintained and that market data from those feeds is properly incorporated into their systems. There will also be substantial system development costs in connection with data retention requirements.

In the Release, the Commission posited that systems changes made by firms to adapt to the requirements of Regulation NMS would ease compliance burdens with respect to the proposed Regulation SHO amendments. While the "devil is in the details," particularly with respect to any exemptions that might be incorporated into the rule, we fear the exact opposite may be the case. It was no accident that the Commission deferred the effective date for members to comply with Regulation NMS until it had eliminated short sale price restrictions in July 2007. The industry warned, and the Commission apparently agreed, that the simultaneous application of the Regulation NMS execution requirements and short sale price test restrictions and exceptions could impose complex, confusing and conflicting obligations on member firms. The need to program systems to accommodate

both rules could raise daunting programming and interpretive questions that will be costly and time-consuming (see below) to resolve.

Firms will be required to revise internal procedures and supervisory procedures manuals and implement surveillance routines. We also anticipate an increase in inquiries from regulators concerning any new restriction. Related additional costs incurred will put tremendous economic strain on market participants already struggling financially. Trading costs will increase, which will be passed along to investors, the same group whose confidence the Commission seeks to restore. We urge the Commission to carefully consider the financial burdens these proposed amendments would impose on market participants, and seek to adopt the most cost-effective model.

Timing of Implementation

As evident from the "Costs" section above, we believe that the proposed three-month implementation period would be utterly insufficient for market participants to implement any of the proposed short sale price restrictions. The Commission's proposition that the work previously done by market participants with respect to Regulation NMS would serve as a foundation for the systems development required for compliance with the proposed amendments does not take into account the integration and programming complexity, and scope of the efforts that will be necessary, as detailed above. We estimate that given all the systems changes and attendant testing protocols required comply with even the most basic short sale price restrictions, market participants will require an implementation period of at least nine months to a year.

Responsibility for Implementation

RBCCMC recommends that the exchanges and electronic communications networks (collectively, the "exchanges") be given the responsibility for the "implementation" of the short sale price restrictions. We believe that the implementation of any price restriction largely depends on the ability of market data feeds to be robust and largely latent free. Accordingly, we urge the Commission to require the exchanges to develop and maintain (and market participants to use) a centralized system that would indicate to market participants where a particular security is trading at any one moment. We believe that leaving this determination up to market participants, who would each need to rely on their own separate market data feeds (of varying quality and latency), will lead to confusion and the potential for gaming. In the event the Commission adopts a circuit breaker approach, we likewise recommend that the exchanges be required to maintain a centralized real-time list of all securities subject to the circuit breaker price test. These and other implementation and administrative functions, to the extent feasible, should be centralized with the exchanges. Such centralization would ensure consistent treatment of orders and help reduce the costs of compliance for market participants.

In the event, however, that the Commission determines to assign the responsibility for the implementation of the restrictions to market participants, we strongly recommend that a flexible "policies and procedures" approach be adopted. As noted above, market

participants will have numerous methods of (and sources of data for) compliance with the restrictions. A flexible policies and procedures approach will give both market participants and self regulatory organizations the leeway to administer compliance in a reasonable manner.

Other Considerations / Recommendations

RBCCMC believes that the Commission should take the opportunity to amend other portions of Regulation SHO that have been the subject of ongoing discussions among market participants. In particular, Rule 204T should be amended and finalized. The requirement under Rule 204T that fail to deliver positions attributable to short sales be closed-out no later than the beginning of regular trading hours on the day after settlement date (T+4), and that fail to deliver positions attributable to long sales be closed-out no later than the beginning of regular trading hours three days after settlement date (T+6) has been the subject of great debate within the industry. While there is no question that the mandatory close-out provisions contained in Rule 204T have dramatically reduced fail to deliver positions and threshold securities (see above), firms' difficulties complying with these time frames are well documented. Many firms find it operationally challenging to distinguish between whether a fail to deliver position is attributable to a short sale or a long sale. In the interest of caution, some of these firms have opted to close-out all fails by the beginning of regular trading hours on T+4. We suggest, accordingly, that the Commission consider extending the close-out requirement under Ruler 204T to the end of the trading day on T+6 for fails to deliver attributable to both long and short sales. In the event that the Commission considers this to be an unreasonable extension of time, we recommend, at a minimum, that the close-out requirement relating to fail to deliver positions attributable to short sales be extended to the *end* of regular trading hours on the settlement day four days following the trade date (T+4).

Section VI of the Release briefly discusses the applicability of the proposed restrictions to transactions executed in overseas markets.¹⁵ Generally speaking, the Commission has taken the position that the provisions of Regulation SHO apply to transactions in covered securities "agreed to" in the United States, but sent to a foreign market for execution. Notwithstanding, there has been ongoing confusion in this area. The Commission should use this opportunity to clarify the applicability of the restrictions (and Regulation SHO generally) to transactions in covered securities executed on overseas markets.

Conclusion

As previously stated, RBCCMC opposes the reinstatement of *any* form of short sale price restriction. There is no empirical data linking the elimination of short sale price restrictions in 2007 with the increased volatility in the marketplace. Likewise, there is no evidence to support the proposition that any of the restrictions proposed in the Release will "restore investor confidence" or "promote market stability." Indeed, recent market stability strongly suggests that investor confidence has been restored. As such, it is

¹⁵ See Release at 158.

clearly premature to reinstate any short sale price restriction without the benefit of a thorough market analysis. In the interim, we recommend that the Commission develop and launch a campaign to educate investors and other market participants as to the sufficiency of current short sale regulation, and the benefits of short selling to the marketplace. That, coupled with a well-publicized enforcement initiative to identify and prosecute abusive short sellers, should help restore "investor confidence" as it relates to short sales.

In the alternative, should the Commission feel it necessary or appropriate to institute some form of short sale price restriction, we advocate that the circuit breaker modified uptick rule, as amended herein, be adopted on a pilot basis.

Sincerely,

Richard T. Chose



One Liberty Plaza
165 Broadway
New York, NY 10006-1404
Telephone (212) 428-6200
(212) 858-7000

September 25, 2008

Chairman Christopher Cox
Commissioner Luis A. Aguilar
Commissioner Kathleen L. Casey
Commissioner Troy A. Paredes
Commissioner Elisse B. Walter
Erik R. Sirri, Director, Division of Trading and Markets
Robert L.D. Colby, Deputy Director, Division of Trading and Markets

Securities and Exchange Commission
100 F. Street, N.E.
Washington, DC 20549

Re: Short Sale Order – Impact on Convertible Arbitrage Market

Dear Sirs and Madams:

The U.S. convertibles market comprises \$300 billion in corporate securities. Recently, this market has been dramatically affected by three factors:

1. Many U.S. financial firms including Lehman Brothers, Washington Mutual, Fannie Mae, and AIG, collectively raised over forty billion dollars in this market in the last year – see the attached list. Valuations on this debt have fallen drastically – in some cases almost to zero. While these losses are a consequence of the distress in these companies' businesses, they have been particularly concentrated in this asset class, leaving these investors in a vulnerable position.
2. Lehman Brothers' Prime Brokerage business in London had a large allocation to the convertible arbitrage business. Hedge funds (the largest investors in this space) that held their prime broker assets at Lehman are facing the potential loss of 100% of those assets. In addition, news is coming out that Lehman may have rehypothecated those assets as collateral for funding arrangements (repos). Lehman's repo counterparties appear to have been heavily selling those portfolios in the market in the last few days in order to recover these loans.

And most pressingly:

3. The Short Sale Order. With the initiation of the Short Sale Order, convertible arbitrage investors can no longer hedge their convertible positions by selling short stocks on the list of covered issues. With the list growing daily, and including an increasing number of firms (such as GM, Ford, IBM, and CVS) that are not primarily financial in nature, market participants have now lost confidence in their ability to buy any convertible security without facing the risk that the underlying stock may be added to the list, thereby impairing their ability to manage the hedging risk of their position.

The exception adopted by the Commission for OTC market-makers, including derivatives market makers, falls short of addressing this problem. The primary investors in converts are bank and broker-dealer proprietary trading desks (such as our convertible arbitrage desk), and hedge funds. Because these desks generally trade strictly for their own account, and are not in the business of facilitating customer or counterparty orders, they do not qualify as market makers.

Even in a normal liquidity environment, conventional convertible sales and trading desks that might qualify under the market maker exception would not have sufficient capital to absorb the supply that we are observing pouring into the market. In the present environment, their ability to take on these positions is woefully inadequate.

The Order has essentially created a situation where there is no end-buyer at a time when there are forced sellers.

This market is therefore in a "perfect storm" which is getting worse by the day. Bank and broker-dealer proprietary trading desks and hedge funds are presently executing a mass liquidation of their holdings of convertible securities at increasingly distressed prices in yet another unfolding "run on the bank" scenario. This could well have the effect of forcing many hedge funds and trading desks out of business. The concomitant effects are:

1. Corporate credit spreads are widening, as investors lower their prices for other corporate bonds and bank debt as the convertibles become relatively cheaper. The IG10 index of corporate credit spreads has widened from 162 to 170 since the order was announced. This will increase fear and cause liquidity in the corporate debt market to be further reduced. This may in turn spread contagion to U.S. corporate debt more generally, and from there to other asset classes.
2. A further loss of liquidity in the repo market, as banks that are already reluctant to take credit exposure to other banks become increasingly uncertain of the value of the collateral supporting inter-bank repurchase obligations.

3. A further loss of liquidity in broad financial markets as other investors become more afraid of hedge fund liquidations.
4. Negative news headlines, further eroding confidence in our financial system, and losses to hedge fund investors that may have to be covered by selling in other non-hedge fund markets.

The ability to hedge part of the risk of convertibles allows us to invest in this debt. Without this ability, we are fearful that the market for convertible securities may follow in the footsteps of the sub-prime, CDO, and auction rate securities markets and effectively cease to function. This asset class has historically been the buyer of "second last resort" ahead of only the Federal Government, as we've seen with financial issuers in the last year.

Convertible positions held by bank and broker-dealer proprietary trading desks and hedge funds are typically only partially hedged with the underlying shares, between 25% and 100% - leaving the investor net long the shares from an economic perspective.

We also note that the call options embedded in the convertibles cause convertible arbitrageurs to be short sellers of stock in rising markets, and buyers of stock in falling markets. Removing this constituency will only increase potential volatility in these names.

We realize that looking out for the interests of proprietary trading desks and hedge funds is not a priority for regulators in the current market turmoil, nor should it be. Nevertheless, the unintended consequences of the emergency short sale rules in constraining the investment activities of these investors are having a disastrous effect on the converts market. We are concerned that these unintended effects are only beginning to be felt, but will cause an accelerating deterioration of the converts market, which will in turn quickly spread to the broader markets and serve as yet another burden on the U.S. economy generally. In this way, an emergency order restricting short sale activity that was intended to provide temporary support and stability to the market is in fact causing the opposite effect.

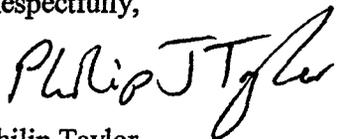
We therefore urge the Commission to consider:

1. An immediate revision to the Short Sale Order, putting in place an exemption for investors who are net long their economic exposure in the underlying equity via a convertible security (whether currently convertible or convertible in the future - the economic position is the same). This needs to be immediate as the consequences of continuing the current restrictions over (or near to) quarter-end will likely result in a "game-over" situation for many of these investors.

2. The Short Sale Order itself should be terminated as soon as possible. Instead, to ameliorate price pressure on distressed financial firms, we recommend that the "uptick rule" be reinstated, either for financial firms or for the market as a whole.
3. DTC settlement records are reviewed so that firms who are consistently guilty of failing to settle short sale trades are vigorously investigated for potential illegal naked short selling.

Thank you for your consideration to our observations on the mounting crisis in the converts market, and our recommendations to address these concerns. We would be pleased to discuss any of these matters further with you or your staff. Please feel free to contact us at phil.taylor@rbccm.com or scott.decanio@rbccm.com, or by telephone at 212-858-7482 or 212-858-7442, respectively.

Respectfully,



Philip Taylor
Director
Convertible Arbitrage Strategies
Royal Bank of Canada



Scott DeCanio
Director
Convertible Arbitrage Strategies
Royal Bank of Canada

cc: Amal Aly, Managing Director and Associate General Counsel
Securities Industry and Financial Markets Association
360 Madison Avenue, New York, NY 10017

List of financial company convertible securities issued since 1/1/2008

Ticker	Name	Size (\$mm)
BAC	Bank Of America C	6,900
LEHM	Lehman Brothers H	6,000
WB	Wachovia Corp.	4,025
PRU	Prudential Financial	3,000
WM	Washington Mutual	3,000
AIG	American Interna	2,500
FNM	Fannie Mae	2,250
C	Citigroup	2,000
KEY	Keycorp	1,500
NCC	National City Corp.	1,437
CIT	CIT Group Inc	1,175
SLM	SLM Corp	1,150
FITB	Fifth Third Bancor	1,000
LM	Legg Mason	1,000
AMG	Affiliated Manager	900
HBAN	Huntington Bancsh	569
NDAQ	Nasdaq Stock Mar	425
MTG	MGIC Investment C	390
MF	MF Global Ltd	300
ABK	AMBAC Financial G	250
WBS	Webster Financial C	225
SIVB	SVB Financial Gr	200
EWB	East West Bancor	175
UCBH	UCBH Holdings I	135
		40,506

