



December 16 , 2008

Via Electronic Filing

Ms. Florence E. Harmon, Acting Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: Release No. 34-58773: File No. S7-30-08;
Amendment to Regulation SHO – Rule 204T

Dear Ms. Harmon:

We commend the Commission for taking aggressive measures to reduce failures to deliver¹ securities on the scheduled settlement date² of a trade in equity securities. Rule 204T of Regulation SHO under the Securities Exchange Act of 1934 (the “Exchange Act”) is designed to reinforce the expectation that trades in equity securities will settle on time.³ In our experience, failures to deliver have significantly declined as a result of the adoption of Rule 204T. We believe, however, that Rule 204T imposes some unnecessary burdens and exposes broker-dealers to financial risk in a manner that was not foreseen when the rule was adopted on an interim final temporary basis on October 14, 2008. Under this extraordinary rule adoption process, the Commission did not obtain public comment before the rule was implemented; rather, the comment period extends from October 14, 2008 to December 16, 2008.⁴ We appreciate the opportunity to suggest some clarifications that the Commission should make if it determines to retain the rule. Although the Commission normally waits until it has assessed the comments on its rule proposal, we urge the Commission to address the issues described below as soon as possible.

¹ See Amendments to Regulation SHO, Exchange Act Release No. 58773, 73 Fed. Reg. 61706, 61707 (Oct. 17, 2008) (“Regulation SHO Amendments”).

² Rule 203(c)(5) of Regulation SHO defines “settlement day” as “any business day on which deliveries of securities and payments of money may be made through the facilities of a registered clearing agency.” 17 C.F.R. § 242.203(c)(5) (2008). See 73 Fed. Reg. at 61711.

³ 17 C.F.R. § 242.204T (2008) (“Rule 204T”).

⁴ See Regulation SHO Amendments, 73 Fed. Reg. 61706.

Rule 204T provides that, if a trade in an equity security does not settle as scheduled and results in a failure to deliver position (“fail position”) in a participant’s account at a registered clearing agency, the participant must take immediate action to close out the fail position.⁵ If the fail position results from a short sale that was scheduled to settle on the third settlement day after the trade date (T+3 settlement days), the participant must take action to borrow or purchase sufficient securities to close out the fail position at or before the opening of trading on the fourth settlement day after the trade date (T+4 settlement days).⁶ If the fail position results from a long sale, the participant must take action to purchase sufficient securities on T+6 settlement days.⁷ For sales of Rule 144 securities, action to purchase securities to close out the position must be taken on T+39 settlement days.⁸

Timing of Mandatory Closeout

We request that with respect to a fail to deliver position that results from a short sale, the Commission change the time by which a participant must close out that position. In this respect, we support the position set out by the Securities Industry and Financial Markets Association (“SIFMA”) in its comment letter (the “SIFMA Letter”) to the Commission on Rule 204T.

Allocation of Fail to Deliver Positions

Rule 204T(d) permits a participant to allocate reasonably a portion of a fail position to another registered broker-dealer for which it clears trades or from which it receives trades for settlement, based on such broker-dealer’s short position (the “allocated broker-dealer”).⁹ If such an allocation is made, then the closeout obligation applies to the allocated broker-dealer, not to the participant.¹⁰

The express language of Rule 204T(d) addresses allocation from the participant to the registered broker-dealer for which the participant clears trades or from which it receives trades for settlement. The allocated broker-dealer, however, may be an introducing firm that forwarded the trade related to the fail position to the participant on behalf of another broker-dealer, which may have been acting for a customer or its own account (the “initiating broker-

⁵ Rule 204T(a).

⁶ Rule 204T(a).

⁷ Rule 204T(a)(1).

⁸ Rule 204T(a)(2). Rule 204T also includes an exception from the closeout and borrowing requirements for bona fide market making activities. A participant that has a fail position attributable to bona fide market making activities by a registered market maker, options market maker, or other market maker is obligated to close out that position at or before the start of trading on T+6 settlement days. Rule 204T(a)(3).

⁹ Rule 204T(d).

¹⁰ *Id.*

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dealer”). Rule 204T does not expressly authorize the allocated broker-dealer to re-allocate the fail position to the initiating broker-dealer.

We request that the Commission clarify that, consistent with industry practice as described in the SIFMA Letter, an allocated broker-dealer may reasonably re-allocate to the broker-dealer from which it received the trade all or a portion of the fail position that it was allocated. Such re-allocation may continue until the fail position is allocated to the ultimate initiating broker-dealer. If the Commission adopts Rule 204T on a permanent basis, either the language of the final rule itself or the discussion of allocation in the adopting release should reflect the ability of an allocated broker-dealer to re-allocate a fail position to the broker-dealer from which it received the trade giving rise to the fail position.

Allocation of Costs Incurred in Closing Out Fail to Deliver Positions

More importantly from a practical and operational viewpoint, the express language of Rule 204T applies only at the pre-closeout stage, that is, when the participant determines that it has a fail position that must be closed out. The rule does not address whether the participant or allocated broker-dealer may allocate to the allocated broker-dealer the *cost* of a closeout purchase that it has made as required by the rule. When the participant or allocated broker-dealer closes out a fail position, it may incur costs, including a loss if it must pay more to purchase the security for closeout than the contract price it receives for the security upon delivery. The participant or allocated broker-dealer should be able, if it reasonably chooses to do so, to pass on those costs to the account or ultimate initiating broker-dealer that failed to deliver the security that resulted in the fail position, consistent with industry practice as discussed in the SIFMA Letter.

We therefore request that the Commission confirm that a participant may reasonably allocate costs incurred in closing out a fail position to an allocated broker-dealer and, further, that an allocated broker-dealer may re-allocate those costs to the broker-dealer from which it received the trade. Further reasonable re-allocation of costs should be permitted to the ultimate initiating broker-dealer. We respectfully request that the Commission or its Staff issue this confirmation as soon as possible, and incorporate it in Rule 204T or an accompanying release when the final rule is adopted.

Relationship of Rule 204T and FINRA Rule 11810

The closeout provisions of Rule 204T do not raise any issues with respect to Financial Industry Regulatory Authority Rule 11810, “Buying-In” (“Rule 11810”). That rule states that a contract that has not been completed by the seller according to its terms may be closed out by the buyer not sooner than the third business day following the settlement date on the trade, *i.e.*, T+6 settlement days on a trade that was scheduled to settle on T+3. Rule 11810 also requires written notice to the seller two business days before execution of a buy-in. The closeout required under Rule 204T is made by a broker-dealer on the sell side of a securities transaction, that is, by a broker-dealer that in some way participated in the execution, clearance or settlement of a customer’s sale. Rule 11810, however, is a separate and distinct process available to the buy side of a securities transaction.

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Nevertheless, there has been some confusion as to the relevance of Rule 11810 to the closeout process required by Rule 204T. There have been instances where a participant has purchased securities as required by Rule 204T, but the broker-dealer responsible for the fail position asserted that the purchase was defective because Rule 11810 was not followed and therefore the broker-dealer should not be responsible for costs associated with the purchase. We believe that it would be helpful for the Commission to remind market participants that Rule 204T imposes distinct obligations on clearing agency participants (or allocated broker-dealers) to close out fail positions and the actions necessary to fulfill those obligations are not subject to FINRA Rule 11810.

A number of broker-dealers are utilizing a service provided by the National Securities Clearing Corporation (“NSCC”) that is used to effect buy-ins on failed trades to complete required closeouts under Rule 204T. When a broker-dealer has a fail position on a long sale that is subject to the T+6 settlement days closeout requirement, the broker-dealer, using NSCC’s service, sends a buy-in notice on T+4 to the broker-dealer who is failing to deliver. The notice advises the other broker-dealer that a closeout purchase will be made on T+6 if the securities are not delivered before then. The NSCC service, however, at present does not have functionality to accommodate the closeout timeframe in Rule 204T. The NSCC service sets the buy-in time as 3:00 p.m. on the buy-in date. Rule 204T, however, requires the closeout to be made on or before the opening of trading on the closeout date. Therefore, broker-dealers using this service must manually change the time from 3:00 p.m. to 9:00 a.m. The manual changes take time and introduce a greater possibility of human error. We therefore request that the Commission work with NSCC to modify its service to accommodate closeout transactions under Rule 204T.

We would be happy to discuss any comments and suggestions above with the Commission or their staffs if that would assist the Commission.

Respectfully submitted,

/s/ Joseph Zangri

Joseph Zangri
Chief Compliance Officer

cc: The Hon. Christopher Cox, Chairman
The Hon. Kathleen Casey, Commissioner
The Hon. Elisse Walter, Commissioner
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