

THE SPECIALIST ASSOCIATION

14 Wall Street, 21st Floor
New York, New York 10005-1901
Tel: (212) 589-0492 Fax: (212) 589-0453
E-mail: tsaofnyse@attglobal.net

Members
New York Stock Exchange

January 29, 2009

Ms. Florence Harmon
Acting Secretary
Securities and Exchange Commission
100 F. Street, NE
Washington, DC 20549-9303

Re: Release No. 34-58773; File No. S7-30-08 – Amendment to Regulation SHO; Interim Final Temporary Rule

Dear Ms. Harmon:

The Specialist Association (“Association”) of the New York Stock Exchange (“Exchange”), an organization whose members, including the recent addition of NYSE Alternext, act as Designated Market Makers (“DMM”) on the Exchange, is pleased to respond to the request of the Securities and Exchange Commission (“Commission”) for comments on the Order Adopting Regulation SHO Interim Final Temporary Rule 204T in Release No. 34-58773 (“Release”) on behalf of members of the Association.

As discussed recently in the Association letter to the Commission dated December 9, 2008 (“Letter”) requesting interpretive relief from certain aspects of the Release, we strongly support the Commission’s efforts to maintain fair and orderly markets and, in particular, its efforts to enhance price transparency and market efficiency. As stated in the Letter, the Release creates certain operational issues in regard to their implementation unique to DMMs, which require interpretive relief from the SEC staff. The immediate relief requested in the Letter is for fails caused by odd-lot assignments as well as extension of the buy-in timing requirement on T+6. The Association herein reaffirms its need for such relief and appreciates the Commission’s consideration of our earlier request.

Below we describe aspects of the Release that affect trading in Exchange listed stocks and the operation of DMMs and describe a de minimis exemption that our members believe is necessary for the proper and efficient functioning of our marketplace. As DMMs at the heart of the price discovery process on the Exchange, we believe that members of the Association bring to bear an especially informed perspective on the dangers of unregulated short selling and the effects of the changes that the Commission has implemented. In formulating these comments, our members have been motivated by concern with respect to our continuing responsibilities for maintaining

fair and orderly markets in listed securities and how the Release has affected our ability to carry out these responsibilities.

We are grateful for the opportunity to submit our views after the date established for comments on the Release.

DMMs' Affirmative Obligation¹

The Association has long agreed with the SEC that short sale regulation has a valid and important purpose – to prevent manipulative or demoralizing short selling that can panic existing holders of a security into selling, thereby creating unwarranted price declines in what otherwise would be fair and orderly markets. As the Commission staff is aware, DMMs hold a unique position as market participants, separate and distinct from floor brokers, traders and other non-Exchange market makers. Regulations require only DMMs to have an “affirmative obligation” to purchase and sell securities as principal when such transactions are necessary to minimize actual or anticipated imbalances between supply and demand in the auction market. Specifically, in the absence of buyers and sellers, DMMs are required to step in and use their own capital to cushion price movements. Without significant DMM participation in these trading situations the result could be an unreasonable lack of price continuity and/or depth. Such lack is the antithesis of price transparency and market efficiency. Certainly a hard delivery requirement for short positions is not new, however the penalty phase of the rule is. Thus, the Association believes that the Commission should take into account that DMMs are subject to meaningful affirmative obligations to make markets at all times and in all conditions and so we ask that the Commission implement the exemption requested below.

Affirmative Obligation & Rule 204T Requirements Analysis

Due to their affirmative obligations, it has become evident that the practical implementation of the Release imposes severe burdens on DMMs to comply with the letter of the rule. Additionally, previously released interpretive relief granted by the Commission to market makers in general is insufficient to permit DMMs to fully comply with both the Release and our affirmative obligations.

For example, for market makers, the Release requires the “Close Out” of a fail to deliver position that is attributable to bona fide market making activities by a registered market maker no later than the beginning of regular trading hours on the third settlement day following the settlement date of the fail. This shall be accomplished by purchasing securities of like kind and quantity. Commission staff interprets the phrase “purchasing securities of like kind and quantity” to include, among other things, that the net purchases be at least equal the amount of the open fail. While the DMM may purchase an amount of securities equal to or greater than the open fail with the express purpose of covering such fail, DMM’s affirmative obligation may require him/her to

¹ See New York Stock Exchange LLC Rule 104T and 104, as amended.

sell securities after the covering transaction and throughout the trading day, resulting in either a long position less than the open fail or a short position at the end of the trading day.

DMM Trading Obligations

Under Exchange rules, the DMM is the contra-party on any and all odd-lot orders throughout the trading day. In this acceptance of odd lot assignments, DMMs, in effect, have no choice; we are forced into positions often to our detriment. In fact, as is often the case, multiple odd-lot orders can cascade in a security in a very short time frame leaving the DMM with a sizable, unintended position in a matter of seconds. While NYSE systems may permit a DMM to gauge his/her odd-lot obligations during the day, the current functionality does not permit either moment-to-moment or end of day management of such assignments. As a result, DMMs execution of intra-day long transactions intended to close out the fail may not be successful.

Over the time period covering the emergency order and the Release, DMMs have had numerous instances where accumulated positions which are due to both the affirmative obligation as well as odd-lot rule requirements have created net short positions in securities which would negate the "pre-fail credit" exemption. While this varies from firm to firm, for each DMM the vast majority of these fails is directly attributable to odd-lot activity. Additionally, post-settlement, these occurrences also undermine a DMM's ability to properly meet the buy-in requirements of the rule.

No Economic Incentive / Prohibitive Borrowing Costs

Furthermore, DMM firms have no economic incentive to fail to deliver. Fails to deliver do not allow the DMM to be paid for the sale, thereby costing the DMM firm an opportunity cost by not being able to re-invest that capital elsewhere. Borrowing costs have increased significantly due to other rule requirements and orders. Also, the difficulty in borrowing certain securities has increased dramatically in recent months especially in relatively illiquid issues. In a recent particularly egregious example, to cover a 74 share short position in a thinly traded security, a DMM on T+5 was forced to borrow 8,000 shares at a significant premium to avoid reallocation of the security.

The increasing inability to borrow and increased costs of borrowing often compel DMMs to buy-in short positions, which often leads to significant price dislocations on certain issues particularly those with low average trading volumes. Due to lack of depth at various price points, DMMs have, on occasion, had to bid 15% to 20% or higher above the last sale to effect the buy-in. In another recent example, to cover an 84 share short, a DMM had to dislocate the price of the security up 24% to complete the buy-in. Such bids do not reflect the true market for the securities, are unfair to the investor community looking for transparency in price discovery and lead to increased price volatility. This is a particular problem at the opening of a security on T+6 when forced buy-ins artificially move the price in a way that disrupts the opening, further

disadvantaging the investing public. For this reason we asked in our earlier Letter for the extension of the timing of the buy in provision of the Release from the opening on T+6 to the close of T+6 which would afford DMMs the opportunity to close out fails with a buy-in where the price more closely reflects the true value of the security.

Re-Allocation

Finally, as a practical matter, pre-borrowing is not a viable alternative for DMMs. There is no reasonable means of coordinating pre-borrowing with the DMM's unpredictable odd-lot obligations, and effecting such "pre-borrows" before market openings is economically prohibitive. As a result of this, the Exchange has decided that if a DMM were to enter the "penalty box" due to a failure to purchase sufficient securities to cover the fail, the Exchange would re-assign the security to another DMM on a temporary basis. This would do nothing to solve the underlying problem. In fact, shuffling it on to the next DMM only compounds the issue. In addition, the transfer process itself would require halting trading of the security which is potentially disruptive and could result in a further increase in volatility. In short, the Association believes that unintended consequences of the rule, in certain circumstances, increase volatility and decrease transparency to such a degree that market prices are no longer reflective of the true value of the underlying securities. Unnecessary short covering creates artificial volume that serves no valid market or investor related purpose.

De Minimis Exemption

Based on the foregoing, the Association therefore requests that Commission consider amending the Release to allow for a de minimis exemption for DMMs of at least 1,000 shares from the close out requirement. Under this exemption, fails to deliver that did not exceed the de minimis amount would not violate any aspects of the Release and so would not trigger any of its remedial provisions. Such an exemption would eliminate the vast majority of difficult to cover fails most of which are caused by odd-lot executions. As has been discussed herein at length, these are trades wherein DMMs are forced, under Exchange rules, to automatically take the contra side. Such accumulated positions leading to numerous fails of relatively insubstantial size (often in fairly illiquid and difficult to borrow securities) that trigger certain onerous results under the Release, have never been the concern of either the Commission or the Exchange when contemplating potential manipulative or fraudulent short selling practices. In fact, we believe that DMMs, by fulfilling their affirmative obligations in taking the contra side in these situations, have the opposite affect. By dampening volatility and promoting price continuity as well as greater market efficiency, DMMs actually reduce any ability to manipulate markets through aggressive and unwarranted short selling.

A de minimis exemption for DMMs for certain short positions would incent behavior that should be encouraged and would have the added benefit of furthering the goals of price transparency and market efficiency.

DMMs take our compliance and Commission regulatory obligations very seriously and believe that with the exemptive relief requested will be able to more responsibly clean up fails to deliver on a timely basis while ensuring reasonable price continuity and depth in our markets. Please do not hesitate to contact me directly at 212-589-0490 should you need any additional information or further clarification.

Sincerely,



David Humphreville
President
The Specialist Association

cc: Chairman Mary L. Schapiro
Commissioner Kathleen L. Casey
Commissioner Elisse B. Walter
Commissioner Luis A. Aguilar
Commissioner Troy A. Paredes
Erik Sirri, Director, SEC Division of Trading and Markets
Robert L.D. Colby, Deputy Director, Division of Trading and Markets
James A. Brigagliano, Associate Director, Division of Trading and Markets