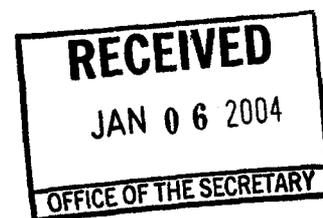




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lawyers@saul.com

www.saul.com

January 5, 2004

Sent Via Federal Express

Jonathan G. Katz, Esquire
Secretary
United States Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

**Re: File No. S7-23-03;
Exception to Proposed Rule 203 (locate and delivery requirements)
for Short Sales Fully Hedged by Certain Public Company Issued
Warrants and Rights**

Dear Mr. Katz:

Saul Ewing LLP is pleased to submit this comment letter on behalf of Greenwood Partners, LP ("Greenwood"). Greenwood is a registered broker-dealer and has been a member of the NASD since March 1998. Greenwood's core business involves the trading of warrants and rights of small-cap publicly traded companies. Greenwood's capital commitment and positive influence in the marketplace relating to these issuers' securities has produced salutary benefits for issuers and public investors, and placed Greenwood in the forefront of the capital formation process for a number of small companies.

I. Introduction

Greenwood applauds the Commission's ambitious rulemaking initiative encompassed in proposed Regulation SHO that calls for a comprehensive review, modernization and recodification of the nation's short sale regulations. Greenwood, however, advises the Commission to proceed carefully, particularly in areas that will be new to federal regulatory oversight. We are concerned about aspects of the proposal to transfer current "locate and delivery requirements" from the rulebooks of the self-regulatory organizations ("SROs") to

Centre Square West ♦ 1500 Market Street, 38th Floor ♦ Philadelphia, PA 19102-2186

Phone: (215) 972-7777 ♦ Fax: (215) 972-7725

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BALTIMORE CHESTERBROOK HARRISBURG NEW YORK PHILADELPHIA PRINCETON WASHINGTON WILMINGTON

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Jonathan G. Katz, Esquire
Secretary
United States Security and Exchange Commission
January 5, 2004
Page 2

Commission regulations. Our key concern relates to the Commission's selective adaptation of NASD requirements in this area without incorporating certain longstanding exceptions that support capital formation for smaller public companies and induce the creation of liquidity in these issuers' securities.

II. Summary of Recommendation

Greenwood respectfully recommends that the Commission amend proposed Rule 203 regarding "locate and delivery requirements" to provide for an exception from such requirements for short sales fully hedged by certain public company issued warrants and rights. Our comment letter sets forth the justification for our request, details the particular challenges in borrowing securities for smaller public companies, and proposes the draft text of the amendment. Such amendment would create a hedge exception that is more narrowly drawn than the current exceptions contained in NASD Rules 3370 and 11830.

III. Regulatory History and Background

In the wake of the 1929 stock market crash, Congress carefully studied short selling practices before enacting the Securities Exchange Act of 1934 (the "Exchange Act"). Because short selling may give rise to both positive and negative effects for the national economy, Congress refrained from legislatively curtailing such practices. Instead, Congress delegated the Commission to provide appropriate checks on potential abusive short selling practices such as "bear raids." Accordingly, the federal statute, Section 10(a) of the Exchange Act, authorizes the Commission to regulate short sales of securities registered on a national securities exchange. In 1937, the Commission used this authority to adopt Rule 10a-1, which permitted short selling so long as it was subject to the governor of the Commission's "tick test." Since adopting Rule 10a-1, the Commission has targeted appropriate categories of trading activities that should be exempt from the tick test. In this regard, the Commission, over the years, has determined that numerous trading activities should be exempted (e.g., odd lot trades, block positioner trades, domestic and international arbitrage trades, VWAP and other passive trades, and Exchange Traded Funds transactions). Hence, the tick test, now being proposed to be changed to a bid test, has been the primary impetus and focus of federal short sale regulations over listed securities for approaching 67 years.

We observe that the Commission is now treading beyond its traditional role, which linked its short sale regulatory authority to the tick test. The Commission is moving into an area that has to date been the sole province of registered SROs, namely the NASD. In this regard, Congress did not provide the Commission authority to regulate short sale practices regarding over-the-counter ("OTC") securities in Section 10(a) of the Exchange Act. Moreover, "locate and delivery" practices, currently subject to NASD Rule 3370 and other analogous SRO rules, have been under the exclusive jurisdictional oversight of the SROs. Although we do not object

Jonathan G. Katz, Esquire
Secretary
United States Security and Exchange Commission
January 5, 2004
Page 3

to the “federalization” of these rules, nor do we question the Commission’s ability to find statutory authority other than Section 10(a) as a basis for federal short sale regulation over OTC securities in general, we implore the Commission to proceed with a high degree of caution, and not destroy or disrupt the well balanced and carefully crafted structure of the current SRO rules in these areas such as NASD Rule 3370 and its attendant exceptions.

We observe that the Commission proposes to incorporate the substance of NASD Rule 3370 as new Commission Rule 203 under the Exchange Act governing “locate and delivery requirements” in “all equity securities.” We are concerned that at least one longstanding exception to Rule 3370 has not been transferred to the Commission’s proposed Rule, which portends grave deleterious consequences for many small-cap public companies, their public investors, and broker-dealers such as Greenwood that support the marketplace for these constituencies.

IV. Long-standing Reliance on Bona Fide Hedge Exception under NASD Rules 3370 and 11830

Since becoming an NASD member in 1998, Greenwood has relied upon the “bona fide hedge” exception provided in NASD Rule 3370 (“Bona Fide Hedge Exception”). See NASD Rule 3370(b)(2)(B). The Bona Fide Hedge Exception provides, in relevant part, that “[n]o member shall effect a ‘short’ sale for its own account in any security unless the member or person associated with a member makes an affirmative determination that the member can borrow the securities or otherwise provide for delivery of the securities by settlement date. **This requirement will not apply to ... transactions that result in fully hedged or arbitrated positions.**” (emphasis added). *Id.*

Rule 3370 provides guidelines for illustrating the scope and meaning of the Bona Fide Hedge Exception with examples of short securities positions being hedged by: (i) convertible securities (e.g., convertible debentures or preferred stock), (ii) long call options, and (iii) warrants and rights. The example of an appropriate hedge relating to warrants and rights is as follows:

Short a security and long a position in warrants or rights which are exercisable within 90 days into the short security. To the extent that the long warrants or rights are “out of the money,” then the short position shall be exempt up to the market value of the long warrants or rights.

Example: Long 100 warrants of IJKL (IJKLW: 2 1/4-2 3/4 or 2.25-2.75). Each warrant is exercisable into 1 share of common at \$2. (IJKL: 4-4 1/2 or \$4-4.50).

Jonathan G. Katz, Esquire
Secretary
United States Security and Exchange Commission
January 5, 2004
Page 4

- With the circumstances as above a short position of 100 shares would be exempt.
- If the price of IJKL is \$1.50 and the market value of long warrants is 1/4 of a point, or \$.25, a short position of 16 shares would be exempt.

NASD Rule 3370(b)(5)(A)(iii).

The Bona Fide Hedge Exception in the context of the NASD's rules also provides an exemption from NASD Rule 11830 that imposes a mandatory close-out requirement for NASDAQ securities that have a clearing short position of 10,000 shares or more per security and that are equal to at least one-half of one percent of the issue's total shares outstanding. Proposed Rule 203 incorporates many of the provisions of NASD Rule 11830. We recommend that the Commission extend a comparable Bona Fide Hedge Exception to Rule 203.

V. Exception Does Not Raise Naked And Manipulative Short Sale Concerns

The Commission stated that the genesis of proposed Rule 203 stems from "complaints from many issuers and investors concerning allegations of abusive 'naked short selling' ... [and] that this requirement would help curtail manipulative short selling." Release No. 34-48709 dated October 28, 2003 at p. 57 ("Regulation SHO Proposal Release"). Greenwood observes that the Bona Fide Hedge Exception, particularly as applicable to hedging activities through warrants and rights, does not give rise to "naked" and "manipulative" short selling concerns.

Greenwood notes that all short sales effected by the firm must comply with tick or bid test requirements, if applicable, regardless of whether the transaction is excepted from locate and delivery requirements. Of equal import, by definition, the Bona Fide Hedge Exception requires that for any short sale to be effected, such sale must be fully hedged by a convertible security that by its terms acts as a full and bona fide hedge to the shorted security. In this regard, from a position risk standpoint, Greenwood is always delta long or neutral when considering that its short stock position will always be fully hedged by warrants or rights that entitle the firm equivalent if not more registered stock than its short stock position. As the supply of warrants and rights are strictly controlled by the public company, naked and unlimited short selling cannot occur if such short positions must be fully hedged by such issuer's warrants and/or rights.

Finally, we are recommending that the exception only cover short sales hedged by warrants or rights that contain terms in their respective issuer agreements that would preclude such instruments from being used to facilitate any form of "death spiral" financing. See discussion under Section IX. below.

Jonathan G. Katz, Esquire
Secretary
United States Security and Exchange Commission
January 5, 2004
Page 5

VI. Exception Assures Fair and Efficient Pricing of Warrants/Rights and Related Common Stock

Greenwood and other market participants who adhere to the Bona Fide Hedge Exception requirements provide critical depth and liquidity and pricing discipline to the marketplace for the company's warrants and/or rights as well as its common stock. Greenwood denotes its role in these markets as that of a delta neutral arbitrageur for capital formation. In this regard, Greenwood looks for pricing dislocations in the warrants or rights and the underlying common stock. If the stock becomes overly rich in comparison to the pricing of its warrants based on conventional options pricing model analysis, the firm will sell the stock and purchase the warrants or rights. The purchase of the warrants and rights provides significant liquidity to the marketplace for these securities and is highly beneficial to investors of such securities. In this connection, public investors who hold warrants and rights for at least one year will be able to recognize favorable capital gains rates by selling such positions in the market rather than exercising such positions into common stock and being taxed at higher ordinary income rates upon the immediate sale of the resultant shares. See Sec. 1 of the U.S. Internal Revenue Code ("IRC") (relating to ordinary income tax rates) and Sec. 1221 of the IRC (relating to capital gains tax rates). Greenwood's presence in the market as an arbitrageur/purchaser of the warrants and rights enable public investors to unwind warrants and rights at fair and more favorable prices. In essence, firms like Greenwood constitute the "invisible hand" of the marketplace that assure fair and efficient pricing for both warrants/rights and the related common stock. Ultimately, Greenwood will exercise such warrants or rights, thereby providing cash to the company in exchange for common stock to cover the short position.

By performing these essential marketplace activities, Greenwood keeps the valuation of the company's common stock in line with that of its warrants and rights. The Commission has stated that "bona fide arbitrage activities are beneficial to the markets because they tend to reduce pricing disparities between securities. These activities carry limited risk of the kind of manipulative or destabilizing trading that Rule 10a-1 was designed to address." Proposed Regulation SHO Release, at p. 24. We stress that Greenwood's ability to sell stock short, albeit limited by the hedge requirement, works as an effective check on potential long side market manipulation schemes that seek to drive share prices up without economic justification. Indeed, Greenwood's functions serve as an important adjunct to Rule 10b-18 under the Exchange Act to safeguard against potential manipulative conduct to increase a stock's price in the context of issuer buy-back transactions.

VII. Exception Critically Supports Capital Formation for Small Issuers

In proposing Rule 203, the Commission stated that it:

Jonathan G. Katz, Esquire
Secretary
United States Security and Exchange Commission
January 5, 2004
Page 6

is also concerned with the impact this proposal may have on small issuers. Please provide data to quantify the costs to small issuers and potential investors in these small issuers, including whether reduced short selling opportunities may make the securities in these markets more susceptible to having overvalued stock prices. In addition, we request comment on the extent to which the recommended proposals may affect the ability of small issuers to secure financing through the issuance of convertible debentures.

Regulation SHO Proposal Release, at p. 59.

NASD Rule 3370 and its Bona Fide Hedge Exception with respect to warrants and rights, were carefully crafted to promote capital formation particularly for small issuers who frequently use such securities in public offerings to enhance the marketability of their common stock, and who have the further strategic objective of raising additional capital in a highly efficient manner as the company grows and its stock price appreciates over time. In this regard, the exercise of a warrant or right infuses immediate capital into the company, in contrast to an exercise of a convertible security or non-company issued option. When Greenwood exercises warrants or rights, the company receives cash from Greenwood in an amount equaling the number of warrants or rights exercised times the exercise price. Raising capital in connection with the exercise of warrants and rights is extremely efficient as secondary offering and/or private placement legal, accounting, underwriter, and placement agent fees are avoided. Moreover, if warrants and rights are exercised gradually over time, they can act as “shock absorbers” to cushion the adverse supply impact on a stock’s pricing as can be caused by a shelf or secondary offering of stock coming to the market all at once. Indeed, many small companies will rely on their warrants and/or rights as the only viable source of funding as such companies may be priced out of the market for traditional investment banking services.

Over the past six years, Greenwood has provided tens of millions of dollars of capital to a multiplicity of small public companies through early warrant or right exercises induced by the Bona Fide Hedge Exception. Recent examples are Intervest Bancshares Corporation (“IBCA”), and TASER International Inc. (“TASR”). With respect to IBCA, Greenwood has purchased and exercised half of the over one million warrants issued, and infused over \$4 million in capital to this small New York bank. With respect to TASR, Greenwood has purchased and exercised TASR warrants at times when such warrants have had three or more years left until expiration. Greenwood’s \$1.8 million cash infusion, to date, has assisted the rapid growth of this company that manufactures leading edge less-lethal weapons to law enforcement and defense agencies.

Greenwood’s arbitrage activities assure timely infusions of capital to companies. In this regard, holders of publicly traded warrants and rights rarely exercise into common stock, and instead liquidate their positions by selling them in the marketplace. Such transference of ownership from one holder to another does not raise any capital for the company. In short, there

Jonathan G. Katz, Esquire
Secretary
United States Security and Exchange Commission
January 5, 2004
Page 7

is little incentive for the ordinary holder to “ante up” the exercise price to purchase the stock when the holder can receive exposure to the same upside potential of the stock by holding and then selling the warrant or right. Accordingly, Greenwood’s arbitrage activities, enabled by the Bona Fide Hedge Exception, uniquely place funds in the hands of companies, which would otherwise happen only at the expiration date of the warrants or rights, and then only so long as the warrants or rights were in-the-money.

Infusions of capital through Greenwood’s Bona Fide Hedge Exception activities reduce the sudden and severe supply shocks faced by a small company when its only alternative is a mass exercise of all its warrants and rights at expiration or upon the triggering of an early call feature by the Company. This sudden increase of public float stock is a destabilizing influence on the company’s stock price. In contrast, Greenwood’s exercises serve to cover positions already absorbed in the marketplace that were initiated on occasions that Greenwood determined that the stock was priced too richly in the marketplace. The latter process prevents sudden stock supply dislocations with concomitant negative impacts on a small company’s stock price.

VIII. Small-cap Marketplace requires more Flexible Delivery Requirements in absence of Developed Stock Loan Facilities

Without the Bona Fide Hedge Exception, firms like Greenwood simply cannot fulfill their current and essential functions to the small-cap marketplace. Generally, brokers have access to deep pools of lendable securities for large and mid-cap issuers created by margin arrangements on such securities. As margin arrangements are severely limited in small-cap securities, brokers’ stock loan programs for these issues are concomitantly limited or non-existent. In this regard, compared to large and mid-cap stocks, stock loan or stock borrow programs respecting small-cap stocks are less developed and may be unavailable for many issues. For instance, there is no analogue in the small-cap arena of the large pools of hypothecable securities available daily in large and mid-cap issues to be lent through clearing firms and other custodians catering to institutional investors. Accordingly, at the point of sale, Greenwood may not be able to determine whether it will be able to borrow the shares to cover the short sale. Greenwood’s short positions, as a practical matter, are covered through warrant and/or rights exercises or otherwise when: (i) its clearing firm makes special requests and/or identifies impending buy-ins, (ii) when Greenwood’s trading strategies so require, and/or (iii) when the warrants or rights are to expire. Greenwood recognizes that clearing firm procedures and NASD buy-in rules assure that Greenwood poses no ultimate delivery failure risk in connection with fully hedged short sales. Consequently, SRO rules such as NASD Rule 3370

Jonathan G. Katz, Esquire
Secretary
United States Security and Exchange Commission
January 5, 2004
Page 8

strike an appropriate balance in providing exceptions such as the Bona Fide Hedge Exception to provide relief from locate and delivery requirements to firms like Greenwood.¹

In another context of proposed Regulation SHO, the Commission refrained from imposing strict settlement delivery requirements on short sale trades. The Commission is proposing new Rule 200 to replace Rule 3b-3. Rule 200, if adopted as proposed, will require a fixed price and quantity of securities to be purchased as essential elements to an “unconditional contract” that establishes a long position for purposes of short sale regulations. The Commission also questioned trading practices associated with contracts where delivery timing was left open. The Commission, however, did not propose an “imminent delivery requirement” in Rule 200, but instead sought comment on the question “[s]hould proposed Rule 200 require a definite time frame that limits when the buyer can consider themselves long, i.e., a buyer would be deemed to own the securities only if the contract contemplates the buyer will receive the securities within 30 days?”

IX. Safeguards against “Death Spiral” Financing

Greenwood hereby provides drafting suggestions to proposed Rule 203 for incorporation of the Bona Fide Hedge Exception for warrants and rights. Our suggestions include certain limitations on the types of warrants and rights that can be used for hedging to avoid any possibility that this exception can be used to facilitate what has been termed as “death spiral” financing. We have reviewed recent Commission enforcement releases in this area and observe that “convertible debentures” are frequently used in these financings. We, of course, are limiting our exception request to warrants and rights. Nevertheless, we see that the feature that could create the problem in any convertible security is the term in an instrument that measures the conversion ratio as a “fixed value of shares” at the time of conversion as opposed to a “fixed price per share.” Greenwood has only engaged in the trading of warrants and rights involving fixed price per share terms. Accordingly, we recommend that only warrants and rights whose agreements provide specific terms that set the conversion ratio by a fixed price per share as eligible for the exception.

X. Recommended Draft Amendments

As previously mentioned in this letter, we strongly recommend that the Bona Fide Hedge Exception be extended to provide relief from “affirmative determination” and “mandatory close-

¹ The Commission recognizes that stocks representing different liquidity and cap-weighting profiles should be treated differently under short sale regulations. In this regard, the Commission has proposed Rule 202 that would create a pilot program that would temporarily suspend the operation of the bid test for certain liquid securities. Moreover, the loss of the Bona Fide Hedge Exception may lead to usurious, manipulative and other abusive practices in the stock loan area thereby reducing the incentive for hedging, imposing costs on liquidity and adversely impacting pricing efficiency of small company stocks.

Jonathan G. Katz, Esquire
Secretary
United States Security and Exchange Commission
January 5, 2004
Page 9

out” requirements of Rule 203 as it currently does so for purposes of NASD Rules 3370 and 11830. To assist the Commission in this area, we have provided draft text of our proposed amendments to Rule 203, redlined to indicate our recommended changes. The amendments are attached hereto as Appendix A.

XI. Conclusion

On behalf of Greenwood, we look forward to providing the Commission with further information to support the Bona Fide Hedge Exception to proposed Rule 203 under Regulation SHO. Please do not hesitate to call me at (215) 972-1888 if you have any questions or comments on this letter.

Sincerely,

SAUL EWING LLP

By: 
William W. Uchimoto

WWU/jc

Attachment

cc: Chairman William H. Donaldson – sent via regular mail w/attachment
Commissioner Paul S. Atkins – sent via regular mail w/attachment
Commissioner Roel C. Campos – sent via regular mail w/attachment
Commissioner Cynthia A. Glassman – sent via regular mail w/attachment
Commissioner Harvey J. Goldschmid – sent via regular mail w/attachment
Annette L. Nazareth, Esquire – sent via regular mail w/attachment
Robert L.D. Colby, Esquire – sent via regular mail w/attachment
Larry E. Bergmann, Esquire – sent via regular mail w/attachment
James A. Brigagliano, Esquire – sent via regular mail w/attachment
Kevin J. Campion, Esquire – sent via regular mail w/attachment
Gregory J. Dumark, Esquire – sent via regular mail w/attachment
Lillian S. Hagen, Esquire – sent via regular mail w/attachment
Elizabeth A. Sandoe, Esquire – sent via regular mail w/attachment
Marla O. Chidsey, Esquire – sent via regular mail w/attachment

APPENDIX A

Redlined text of proposed amendments to Rule 203, with new text bold and underscored.

§ 242.203 Borrowing and delivery requirements.

(a) Long sales. (1) If a broker or dealer knows or has reasonable grounds to believe that the sale of a security was or will be effected pursuant to an order marked "long," such broker or dealer shall not lend or arrange for the loan of any security for delivery to the broker for the purchaser after sale, or fail to deliver a security on the date delivery is due, unless the broker or dealer knows or has been informed by the seller that the seller owns the security and will deliver it to the clearing broker or dealer prior to the scheduled settlement of the transaction.

(2) The provisions of paragraph (a)(1) of this section shall not apply to:

(i) The loan of any security by a broker or dealer through the medium of a loan to another broker or dealer; or

(ii) Any loan of, arrangement for the loan of, or failure to deliver any security, if, prior to such loan, arrangement or failure to deliver, a national securities exchange, in the case of a sale effected thereon, or a national securities association, in the case of a sale not effected on an exchange, finds:

(A) That such sale resulted from a mistake made in good faith;

(B) That due diligence was used to ascertain that the circumstances specified in § 242.201(c) existed; and

(C) Either that the condition of the market at the time the mistake was discovered was such that undue hardship would result from covering the transaction by a "purchase for cash" or that the mistake was made by the seller's broker and the sale was at a price permissible for a short sale under § 242.201(b).

(b) Short sales.

(1) A broker or dealer may not execute a short sale order for its own account or the account of another person unless the broker or 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.

(2) The provisions of paragraph (b)(1) of this section shall not apply to short sales executed by specialists or market makers in connection with bona-fide market making activities.

Bona-fide market making activities shall not include activity that is related to speculative selling strategies or investment purposes of the broker or dealer or is disproportionate to the usual market making patterns or practices of the broker or dealer in that security.

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

(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 (15 U.S.C. 78q-1) of the 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 NASD and the Examining Authority (as defined in 15c3-1(c)(12)) 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 that otherwise would be made to the participant failing to deliver, and assess appropriate charges.

(4) The provisions of paragraphs (b)(1) and (b)(3) of this section shall not apply to short sales in any security fully hedged by a long position in warrants or rights which are: (i) exercisable within 90 days into the short security and (ii) subject to a fixed price per share conversion ratio. To the extent that the long warrants or rights are "out of the money," then the short position shall be exempt up to the market value of the long warrants or rights.

(c) Upon written application or upon its own motion, the Commission may grant an exemption from the provisions of this section, either unconditionally or on specified terms and conditions, to any transaction or class of transactions, or to any security or class of securities, or to any person or class of persons.