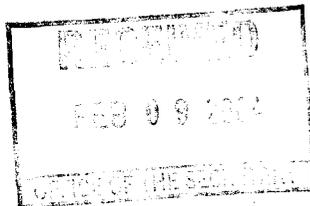


Schwab Capital Markets, L.P.
111 Pavonia Avenue East, 15th Floor Jersey City NJ 07310

January 5, 2004

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549



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Re: Securities and Exchange Act Release No. 48709; File No. S7-23-03

Dear Mr. Katz:

Charles Schwab & Co., Inc. and Schwab Capital Markets L.P. (both hereinafter referred to as "Schwab"), registered broker-dealers of The Charles Schwab Corporation, appreciate the opportunity to comment on the Securities and Exchange Commission's ("Commission") proposed Regulation SHO, which will alter the regulatory structure governing short sale transactions. Regulation SHO, if adopted, will replace Rules 10a-1, 10a-2, and 3b-3 under the Securities Exchange Act of 1934 ("Act") and harmonize the regulation of short sales among self-regulatory organizations ("SROs").

Schwab, as one of the world's leading broker-dealers, offers its millions of customers a wide variety of services including advice, asset management, independent research, and order execution in exchange-listed ("listed") and Nasdaq securities through multiple market centers. Schwab's paramount interest is to provide the highest standard of investor service. For this reason, we are very pleased that the Commission has undertaken an effort to modernize the regulations governing short sale transactions.

Short selling plays a vital role in the efficient operation of the capital markets by providing liquidity to buyers in rising markets, liquidity to sellers in declining markets through short covering and a check on exuberant stock pricing in all markets. Advances in technology and innovation among competing markets, however, have outstripped the regulatory framework applicable to short selling, particularly for listed securities. With Rule 10a-1, the listed short sale rule, largely unchanged since the 1930s, trading in listed securities suffers from inefficiencies unrelated to the anti-manipulative purpose behind the rule. With regard to securities listed on Nasdaq, the absence of Nasdaq's short sale rule in all markets trading Nasdaq securities has lead to claims of regulatory arbitrage. Clearly, the time is ripe for a comprehensive overhaul of short sale regulation.

Schwab believes that the best markets are those that operate freely such that a willing buyer can meet a willing seller as efficiently as possible. At the same time, however, we also believe that some short sale regulation may serve an important investor protection

purpose in preventing possible manipulative abuses in less liquid securities. Issuers of securities have legitimate concerns with attempts to manipulate stock prices lower through so-called "bear raids." As well, the clearance and settlement system must be assured of its integrity by requiring that sales of securities be backed by delivery of securities upon settlement date. Most importantly, the Commission should not limit the ability of market makers to provide liquidity to their customers by imposing overly restrictive short sale constraints. In presenting these comments, therefore, we recognize the difficult balance that the Commission is seeking to achieve in terms of protecting investors and accommodating the legitimate needs of a competitive marketplace.

We Support Modernization of Short Sale Regulation

While the proposing release raises a host of important issues with respect to short sales and the development of effective regulation in this area, we want to focus our comments on those issues that most likely will affect our customers. Foremost among our concerns is that the Commission modernize the regulatory structure for short selling in a manner that promotes competition and innovation.

Investors have benefited in recent years from a profound narrowing in spreads as a result of decimalization. In addition, Commission rule changes in the 1990's opened the door to new execution venues that brought increased competition to the Nasdaq market, although similar reform of the market for listed securities remains before the Commission.

Schwab believes that short sale reform will similarly benefit investors, particularly the standardization of rules and the pilot reform that eliminates short sale regulation for a subset of the Russell 1000. Among the most liquid securities, we believe that the opportunities to manipulate the markets in the manner that Rule 10a-1 and SRO rules were designed to prevent has been significantly reduced, if not eliminated. Moreover, advances in SRO and broker-dealer audit trail technology have enhanced the ability to detect and prosecute manipulative short selling. We believe that as the Commission develops data during the pilot period, unrestricted short selling may be expanded to more securities.

We Support Uniform Application of Short sale Regulation

We support the Commission's initiative to harmonize short sale regulation across markets. In our view, having one rule for listed securities and another for Nasdaq securities has made little sense. We are pleased to see that the Commission is not seeking to maintain different rules for different markets based on whether markets are registered as exchanges or as national securities associations. Such distinctions are as irrelevant to short sale regulation as they are to other market structure rules.

Also, harmonizing short sale regulation will eliminate the current controversy where certain SROs have no short sale for Nasdaq securities while Nasdaq enforces NASD

Rule 3350, the NASD short sale rule. Although there has been no evidence of short sale manipulation on the SROs lacking short sale rules, the Commission might well review activity on such markets to better understand the implications of trading without short sale rules. Schwab believes, however, that competition among markets should be played on a level field. While this standard applies well beyond short sale regulation, one market should not be given a competitive advantage through a different set of regulatory requirements.

We Support the Implementation of a Uniform Bid Test for Short Sale Regulation

Under proposed Regulation SHO, a uniform price test would apply to listed and Nasdaq securities, wherever they are traded. Nasdaq Small Cap and Bulletin Board securities would not be included within the regulation. If Schwab were to choose between extending the tick test of Rule 10a-1 to all securities and Regulation SHO, we would prefer Regulation SHO. However, our first choice would be to extend NASD Rule 3350 to all securities.

As the Commission has noted, because the tick test of Rule 10a-1 is based on the reported last sale price, it is inappropriate as a market-wide standard because the reporting of last sale prices is no longer sequential among the markets trading listed securities. Although the Commission recognized this phenomenon, they argue that it has not caused difficulty for the listed market because the NYSE retains 87 percent of volume in its listed securities.

Schwab does not agree. With the NYSE specialist often trading through its own quoted market, the sequence of trades reported to the Consolidated Tape Association ("CTA") is distorted causing tick test problems for all markets. Adding competing markets to the mix, markets with varying speeds of transaction processing, i.e., some fully automated while others require manual processing, only exacerbates the non-sequential nature of the CTA tape. The CTA tape produces a stream of last sale prices or ticks that are unrelated to previous and subsequent transactions. Because Rule 10a-1 bases its regulation on last sale prices, the aberrant ticks introduce significant impediments to legitimate short selling and thereby impede the efficiency of the market. Thus, by necessity, we agree that the Commission must eliminate Rule 10a -1 and adopt a bid test similar to NASD Rule 3350 or the proposed uniform price test as it moves towards the implementation of a uniform standard.

In many respects, NASD Rule 3350 and the Commission's proposed uniform price test are similar. Both rules permit greater flexibility in executing short sale transactions than the tick test of Rule 10a-1. However, between NASD Rule 3350 and the Commission's proposed rule, Schwab supports adoption of the NASD rule as the best market-wide rule for short sale regulation. While both rules prohibit executing short sales on bids in declining markets, proposed Regulation SHO would prohibit executing short sales on bids in rising markets. Schwab fails to see the need to be so restrictive. We believe that "hitting bids" in rising markets provides necessary liquidity to purchasers and acts

as a check on unreasonably exuberant stock prices. Moreover, hitting bids in rising markets is not contrary to the reasons Congress enacted short sale regulation seventy years ago. Interacting with bids that are higher than previous bids is not analogous to accelerating a decline in stock prices by eliminating successive price levels, the principal concern behind short sale regulation. Unless the Commission reconsiders its view with respect to up bids, Schwab supports NASD Rule 3350 over proposed Regulation SHO.

Finally, from a practical perspective most broker-dealers have programmed for NASD Rule 3350 for their OTC trading desks. Expansion of this programming to listed securities would not be significantly expensive. Should the Commission adopt Regulation SHO as proposed, however, firms will incur substantial reprogramming costs, costs that would not necessarily relate to better regulation.

A. Compliance should be measured at time of order placement

One area in which we wish to express concern regards the measurement period for compliance with proposed Regulation SHO. New execution systems, competing market centers, and decimalization have forced broker-dealers to rely on the systems of third parties to assure compliance with short sale rules at the time of execution. Because of the rapid fluctuations in quotes and system limitations, orders that are in compliance with NASD Rule 3350 bid test at the time that they are transmitted by the broker-dealer to a market center for execution, electronically or otherwise, may not actually be executed in compliance with the NASD short sale rule due to intervening bids.

This problem has become acute due to fluctuating bids, the microsecond speed at which quotations, orders and executions are transmitted, and the system limitations that may cause a legitimate short sale execution to appear as not in compliance with the rule. Firms should be granted a reasonable relief for flickering bids and simultaneous executions provided that the firm can substantiate that the execution was compliant with the bid reference test within some reasonable time. In addition, we believe that the Commission should adopt a safe harbor for firms that employ reasonable procedures and a consistently applied methodology for measuring short sale compliance. Only in this way may inadvertent short sale violations be segregated to the extent necessary to avoid unreasonable compliance concerns.

We Oppose Application of Short Sale Regulation in After-Hours Trading

As the Commission notes, there currently is a disparity between the hours of application of Rule 10a-1 and current NASD Rule 3350. The Commission has taken the position that Rule 10a-1 applies to transactions in listed securities regardless of the time of execution. In contrast, NASD Rule 3350 limits short sale transactions only during the regular trading hours of 9:30 a.m. to 4:00 p.m.

Proposed Rule 201 of Regulation SHO would extend the application of the short sale limitations to all transactions outside regular trading hours. Transactions occurring outside of regular trading hours may be subject to greater volatility and quotations may not reflect the true supply and demand of a security. For this reason, we accept that someone may attempt to manipulate a security during after-hours trading because the real buyers and sellers would not be present in the market. However, the very fact that regular trading will begin again the next morning discounts any ability to effectively manipulate stock prices. After-hours manipulators are more likely to suffer losses on their attempts, as they are to profit. Moreover, to our knowledge, no institution or mutual fund marks its daily positions off of after-hours transactions.

We also believe that after-hours manipulators are as likely to manipulate stock prices higher as lower. We have to emphasize that the Commission did not cite any history of short sale problems in after-hours trading under the current NASD rules. And, it did not indicate why manipulative concerns would be any greater with respect to short rather than long transactions or between upside manipulators and downside manipulators.

We are concerned that requiring short sale transactions to meet the requirements of stale bids, or closing transactions, would frustrate legitimate trading interests, particularly in light of news or other events which may rightly influence the price of a security in after-hours trading. For these reasons, we recommend that the Commission limit the application of Regulation SHO to regular trading hours.

We Support a More Robust Customer Facilitation Exemption

As the Commission is aware, NASD 3350 currently exempts from operation of the bid test short sales executed by qualified market makers in connection with bona fide market making. There is no similar exception in Rule 10a-1. Based on a rationale articulated more fully in the proposing release, the Commission is not incorporating the current NASD exception into Regulation SHO in its entirety. Nevertheless, the Commission is retaining an exemption to permit market makers to facilitate riskless principal transactions.

Schwab continues to believe that the market maker exemption provided by NASD Rule 3350 is vital for the efficient servicing of customer orders. The ability to provide liquidity to customers upon demand necessitates that market makers be able to respond quickly to changing market conditions. Restricting a market maker from restoring inventory balance threatens that market maker's capacity to provide liquidity when its customers need it most.

In light of the Commission's proposed elimination of the market maker's general short sale exemption, however, Schwab strongly requests that the Commission expand on the customer facilitation exceptions the Commission has already included in proposed Regulation SHO. Recognizing the need to enhance the facilitation of customer orders, the Commission proposed a riskless principal exception that would allow a broker-

dealers to execute customer transactions on a riskless principal basis by looking at the customer's long or short position rather than the executing off of the broker-dealer's position. In addition, the Commission proposed to except from proposed Rule 201 short sales executed pursuant to a requirement of the federal securities laws or SRO rules, such as NASD IM 2110-2 (Manning Interpretation). These provisions provide a portion of the flexibility needed to meet customer needs.

Before discussing the scope of the appropriate market maker exemption, we urge the Commission to take care in defining riskless principal transactions as proposed in Rule 201 of Regulation SHO. In recent years, multiple NASD Notices to Members, Nasdaq Head Trader alerts and FAQs have addressed the complex issues relating to riskless principal transactions. In Schwab's view, in order to assure that firms are not confronted with inconsistent regulatory requirements, it is important that the Commission incorporate existing interpretations of the term riskless principal into its proposed definition.

On a broader point, however, Schwab is concerned with the narrowness of the proposed facilitation exceptions. The narrowly framed exceptions leave equally important customer order facilitations subject to the full impact of the short sale restrictions, while such transactions offer very little risk of short sale abuse. For example, Market-on-Close ("MOC") orders will be extremely difficult to facilitate under Regulation SHO. Proposed Rule 200 of Regulation SHO will deny MOC orders the status of unconditional contracts to purchase securities. Subparagraph (b) of Rule 200 will require that the purchase contract specify the price and amount of the securities involved in the transaction. While Schwab believes that specifying a "closing" price should be sufficient to meet the proposed rules specificity requirement, it seems that the Commission believes otherwise. Because MOC orders are therefore not unconditional contracts, the corresponding customer long position behind the customer sell order cannot be imputed to the executing market maker as permitted by the proposed riskless principal exception in Rule 201 of Regulation SHO.

Another requirement of the riskless principal exception is that the prices received by the market maker be the same price given to the customer orders. Because market makers will execute riskless principal sales before the close to be in a position to provide liquidity to MOC sell orders, the pre-close sales by the market maker will invariably be at different prices than the closing price guaranteed the customer orders. It would seem then that the riskless principal exception to the proposed short sale rule is not applicable to MOC orders.

MOC orders and Market-on-Opening ("MOO") orders are popular reference prices for retail and institutional transactions. At a minimum, we encourage the Commission to expand the customer facilitation exceptions to include MOC and MOO orders. Indeed, the Commission referenced the vital role played by market makers in facilitating customer orders by excepting them from the requirements of the proposed "locate" rule. The Commission stated that a market maker exception is necessary because of the

need to facilitate customer orders in a fast moving market. The same logic applies with regard to the short sale rule itself.

A more appropriate solution would be to permit market makers to be exempt from the short sale rules whenever customer orders are being facilitated. Schwab does not seek exemptive relief to engage in naked short selling on a proprietary basis. Rather, satisfying customer needs, particularly where no short sale manipulation is possible, should guide the Commission's exemptive policy.

We support the Pilot Program for Liquid Securities

While we have commented directly on the application of the proposed short sale rule, we support the Commission's effort to explore whether a broader exemption may be warranted with respect to those securities that are the most actively traded. Given the difficulty in manipulating high volume securities, we agree with the Commission's pilot program as an initial attempt to examine the need for short sale regulation in such securities. We believe that as the Commission gains experience with trading in active securities without the constraints of the short sale rule, the Commission may see its way to expand the universe of securities that may be so freely traded. We caution the Commission, however, to consider a shorter period for review of trading behavior. We believe that some shorter period than two years may generate sufficient guidance to fully understand the broader implications of the pilot program.

Conclusion

We thank the Commission for bringing forth the proposed rulemaking on short sale regulation. The Commission's effort to modernize the application of short sale rules to today's trading environment is certainly timely and necessary for the future development of the markets. Schwab feels strongly that the Commission, by acting swiftly to reform the outdated short sale regulatory structure, may open the door to increase competition and innovation among and within the securities markets. Our principal concern is that through the final rules the Commission not impede a broker-dealer's ability to best serve its customers' interests. We would be pleased to meet with the staff on this subject or to provide additional information with respect to any of the comments that we have provided in this letter.

Sincerely,

By: 

Jeffrey T. Brown

Senior Vice President and General Counsel, Schwab Capital Markets, L.P.

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
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