



VIA ELECTRONIC MAIL

December 14, 2005

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
100 F. Street, NE
Washington, DC 20549-9303

Re: Release No. 34-52752; File Number SR-NASD-2004-044
Short Sale Delivery Requirements

Dear Mr. Katz:

The Regulation SHO Working Group of the Securities Industry Association (“SIA”)¹ appreciates the opportunity to comment on the above-referenced rule filing by the National Association of Securities Dealers, Inc. (the “NASD”) dated November 8, 2005 (the “Proposed Rule Change”).² The Proposed Rule Change would create a new Rule 3210, which is intended to extend the delivery requirements of Regulation SHO to all non-reporting OTC equity securities that exceed an identified level of fails.³

As discussed in further detail below, the SIA believes that the Proposed Rule Change in its current form is not in the best interests of the U.S. capital markets. As an alternative to the NASD’s proposal, the SIA respectfully submits that the Securities and Exchange Commission (the “Commission”) could propose amending Regulation SHO’s delivery requirements in a uniform manner as a part of the Commission’s impending review of the Regulation SHO Pilot program, which is due to expire in April 2006, or otherwise as the Commission deems appropriate. The SIA believes that this alternative course of action would provide an opportunity for the Commission to solicit comment on the merits of extending the close-out requirement to

¹ The Securities Industry Association brings together the shared interests of approximately 600 securities firms to accomplish common goals. SIA’s primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated \$236.7 billion in domestic revenue and an estimated \$340 billion in global revenues. (More information about SIA is available at: www.sia.com.)

² Securities Exchange Act Release No. 52752 (November 8, 2005), 70 FR 69614 (November 16, 2005) (“Notice of Proposed Rule 3210”).

³ *Id.*

non-reporting issuers, while simultaneously preserving the regulatory uniformity that the Commission sought to establish in implementing Regulation SHO.

I. Background

On March 10, 2004, the NASD originally filed with the Commission SR-NASD-2004-044 (the “2004 Proposed Rule Change”), which proposed amendments to Rule 3210 to impose delivery requirements on short sales in all classes of equity securities. However, rather than approving the 2004 Proposed Rule Change, in August 2004 the Commission instead adopted Regulation SHO, which provided a uniform regulatory framework governing short sales of securities.⁴

Among other provisions, Rule 203(b)(3) of Regulation SHO imposes certain requirements on a participant of a registered clearing agency, namely to take action to close-out fail to deliver positions in identified securities that have aggregate settlement failures exceeding a certain percentage. A list of such “threshold securities” is calculated and disseminated daily by the self-regulatory organization (“SRO”) on which the security is listed or for which the SRO bears primary surveillance responsibility. Specifically, a threshold security is defined to mean any equity security that is registered pursuant to Section 12 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), or where the issuer of such equity security is required to file reports pursuant to Section 15(d) of the Exchange Act, and which security has been, for five consecutive settlement days, the subject of aggregate fails to deliver at a registered clearing agency of at least 10,000 shares that are also equal to at least 0.5% of the issue's total shares outstanding (“TSO”).⁵ This delivery framework was not extended to non-reporting securities, due to the fact that measuring the percentage of TSO would have been difficult in practice with respect to non-reporting issuers.⁶

Regulation SHO was expressly intended to implement a uniform regime with respect to the standards and requirements applicable to the acceptance of long and short orders, the marking of long and short sale order tickets, the requirement to “locate” securities available for borrowing, and the handling of failures to deliver and buy-ins. With respect to this final issue, the Commission expressly stated in the Regulation SHO Adopting Release that “[f]or covered securities, Rule 203 supplants current overlapping SRO rules.”⁷ The Commission specifically noted that most of those commenting on the Regulation SHO proposal welcomed the replacement of these disparate SRO requirements.⁸ The Commission also stated that one of the

⁴ Securities Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004) (the “Regulation SHO Adopting Release”).

⁵ 17 CFR 242.203(c)(6).

⁶ Regulation SHO Adopting Release at 48016-17, n. 86; *see also* Division of Market Regulation: Key Points About Regulation SHO, Section IV.A.1.

⁷ *Id.* at 48014.

⁸ *Id.* at 48013-14, n. 53.

benefits of uniform short sale regulation was the furtherance of “the goals of regulation simplification and avoidance of regulatory arbitrage.”⁹

The NASD has now resurrected the 2004 Proposed Rule Change for the Commission’s consideration, albeit changing the requirements of the proposed rule so as to extend the Regulation SHO close-out requirements to cover “non-reporting threshold securities.” These would be defined as equity securities of an issuer that is not registered pursuant to Section 12 of the Exchange Act and for which the issuer is not required to file reports pursuant to Section 15(d) of the Exchange Act, for which: (i) there is an aggregate fail to deliver for five consecutive settlement days at a registered clearing agency of 10,000 shares or more, and (ii) for which on each settlement day during the five consecutive settlement day period, the reported last sale during normal market hours for the security on that settlement day would value the aggregate fail to deliver position at \$50,000 or more.¹⁰

II. Discussion

A. Adopting Proposed Rule 3210 Risks Undermining the Regulatory Uniformity Provided by Regulation SHO

The SIA believes that the 2004 Proposed Rule Change was not adopted because the Commission took express action to institute a uniform regulatory framework for the regulation of short sales, ultimately adopted in Regulation SHO. In its current form, the Proposed Rule Change risks the present uniformity under Regulation SHO by creating additional rules which would not apply outside the individual SRO’s membership. Such an approach could create exactly the situation that the Commission feared, whereby industry members could effectively choose their regulatory regime based on their participation in a given SRO.¹¹ Moreover, separate rules could be subject to potentially disparate revisions and/or interpretations, thereby subjecting certain firms to different buy-in and delivery requirements, depending on which securities were at issue. This could impose attendant systems and compliance costs upon such firms. As such, the SIA believes that the same Commission concerns regarding regulatory arbitrage and the need for a uniform regulatory regime that led to the adoption of Regulation SHO in 2004 should similarly prevent the approval of the Proposed Rule Change today.

The SIA thus strongly believes that the concerns intended to be addressed by the Proposed Rule Change should instead be considered in connection with any other proposed amendments to Regulation SHO. This would ensure that such proposals are vetted through a full notice and comment process, while also preserving a uniform regulatory framework. With the Regulation SHO Pilot Program currently due to expire on April 28, 2006,¹² the SIA believes that the Commission will likely need to take some action with respect to Regulation SHO prior to such time. Therefore, the substantive objectives and public policy concerns at which the Proposed Rule Change is directed could be reviewed and appropriately addressed as part of any

⁹ *Id.* at 48025.

¹⁰ *See* Notice of Proposed Rule 3210 at 69615.

¹¹ *See* Regulation SHO Adopting Release at 48025.

¹² *See* Securities Exchange Act Release No. 50747 (November 29, 2004), 69 FR 70480 (December 6, 2004).

other proposed amendments to Regulation SHO, either upon the Commission's review of the Pilot Program, or otherwise as the Commission deems appropriate.

B. The Proposed Rule Change Would Impose a Potentially Significant Burden on the Industry

In adopting Regulation SHO, the Commission took care to select a calculation for "threshold securities" that "characterize[d] situations where the ratio of unfulfilled delivery obligations at the clearing agency at which trades are settled represent[ed] a significant number of shares relative to the company's total shares outstanding," while at the same time seeking to ensure that such calculation would not "burden the vast majority of securities where there are not similar concerns regarding settlement."¹³ As part of this effort, prior to adopting Regulation SHO, the SEC's Office of Economic Analysis had carefully analyzed recent data from the National Securities Clearing Corporation (the "NSCC") on fails to deliver and calculated that approximately 3.9% of all exchange-listed and Nasdaq securities, and 4.0% of all securities, would meet the requirements to be "threshold securities."¹⁴

The NASD did not state as part of its filing that it has performed a similar analysis in connection with the Proposed Rule Change, despite the possibility that it could impose a substantial burden on the market. To the extent that such an analysis has been performed by the NASD, the SIA requests that the results be made available. If not, the SIA believes that the Commission should request that the NASD perform such an analysis in order to determine the number of additional securities that would be captured under the NASD's proposed calculation. The results of such an analysis would permit firms to evaluate the full impact of the Proposed Rule Change on their procedures and systems.

C. The Proposed Rule Change Could Have Unintended Negative Consequences in the Markets for Non-Reporting Threshold Securities

The unclear, but potentially substantial, burdens that the NASD's Proposed Rule Change could impose on member firms raise the likelihood of unintended actions that may be taken in response. Specifically, one possible concern is that the Proposed Rule Change could cause some firms to altogether refuse to process trades in the new "non-reporting threshold securities" in order to avoid having the level of fails in these securities that would cause them to be subject to the Proposed Rule Change's close-out requirements. If such a response occurred, this could serve to further reduce liquidity in securities that are oftentimes already very illiquid.

Furthermore, SIA member firms have expressed concern over the potential for the Proposed Rule Change to distort the market's price-reporting function. In particular, the increased execution of buy-ins in very thinly-traded "non reporting threshold securities" could have an even greater price impact than with respect to the current universe of "threshold securities" as defined in Regulation SHO. This could cause the mistaken appearance of buy-side interest in such "non-reporting threshold securities" and thus result in the stock price of such a

¹³ See Regulation SHO Adopting Release at 48016.

¹⁴ *Id.* at 48016-7.

security becoming artificially inflated for a temporary period and then decreasing to a level at which it should be trading based on the fundamentals of the particular security. This price fluctuation bears the potential to harm any investors that, in the interim, have purchased such a security at the inflated price.

In the alternative, should the Commission be inclined to approve proposed Rule 3210, the SIA requests that the NASD address whether the rule will permit any flexibility in the event of illiquidity in a particular “non-reporting threshold security.” In particular, many SIA member firms believe that the proposed \$50,000 threshold in the Proposed Rule Change is very low, and thus could potentially result in a vastly expanded universe of “threshold securities.” Given the fact that many of these “non-reporting threshold securities” may have low levels of liquidity, firms attempting to comply with the buy-in requirement imposed by the Proposed Rule Change could have a potentially extreme impact on the market price of these securities. This could not only negatively impact individual investors in the manner described above, but could impose an onerous burden on member firms in the event they are required to execute a large buy-in with respect to a very illiquid security. As such, the SIA requests that proposed Rule 3210 contain a provision allowing firms to petition the NASD for relief from the requirement to close-out fails in “non-reporting threshold securities,” in a manner consistent with Rule 15c3-3(n) under the Exchange Act, which provides a mechanism for broker-dealers to petition the SROs for relief from the requirement to buy-in customer “long” sales under Rule 15c3-3(m). As heretofore noted, if the Proposed Rule Change was instead proposed for inclusion in Regulation SHO, as requested by the SIA, the ability to petition for flexibility regarding the close-out requirements could be encompassed in the Commission’s general exemptive authority provided in Rule 203(d) of Regulation SHO.

D. Existing Short Sale Regulations Allow for Alternatives to Proposed Rule 3210

Finally, the SIA believes that while the NASD’s Proposed Rule Change may be motivated, at least in part, by concerns from certain Pink Sheet issuers that they are currently not protected by the requirements of Regulation SHO, the SIA would like to point out that this is not in fact the case. In particular, as the Commission is well aware, Rule 203(b)(1) of Regulation SHO requires, absent an applicable exception, that a broker-dealer “locate” securities available for borrowing “prior to effecting a short sale in any equity security.”¹⁵ This requirement may be difficult to satisfy for the proposed universe of “non-reporting threshold securities.” The SIA would suggest that if concerns exist about whether certain market participants are properly complying with the locate requirement or properly relying on an applicable exception from such requirement, the proper solution would be for the NASD to perform targeted inquiries of such market participants, rather than requiring all member firms to incur the added costs and obligations associated with this new class of “non-reporting threshold securities.”

Finally, a large number of SIA member firms believe that supplementing the existing Regulation SHO regulatory regime with SRO rules governing “non-reporting threshold securities” would be premature at this time, given that firms are still adapting their processes and procedures to ensure compliance with the ongoing interpretations from the Commission staff regarding the current requirements in Regulation SHO applicable to “threshold securities” as

¹⁵ Regulation SHO Adopting Release at 48014.

defined in Rule 203(c)(6).¹⁶ As mentioned above, member firms strongly urge the Commission to consider the objectives and public policy concerns at which the Proposed Rule Change is directed as part of amendments to Regulation SHO, thus ensuring a uniform approach and avoiding potential regulatory arbitrage.

III. Conclusion

The SIA respectfully urges the careful consideration of the above comments and questions regarding the Proposed Rule Change as the SIA believes that, in its current form, the Proposed Rule Change does not appear to be in the best interests of the U.S. capital markets. If you have any questions, please contact the undersigned at (212) 618-0568, or Kevin J. Campion, Sidley Austin Brown & Wood LLP, at (202) 736-8000.

Sincerely,

Amal Aly
SIA Vice President and
Associate General Counsel

cc: The Hon. Christopher Cox, Chairman
The Hon. Cynthia Glassman, Commissioner
The Hon. Paul Atkins, Commissioner
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¹⁶ 17 CFR 242.203(c)(6).