INTERACTIVE BROKERS GROUP

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Via Electronic Mail and Regular Mail

Dr. Erik Sirri
Director, Division of Trading and Markets
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: ***Operational Issues and Comments on SEC Emergency Rule 204T***

Dear Dr. Sirri:

Interactive Brokers Group, on behalf of its subsidiaries Interactive Brokers LLC and Timber Hill LLC[1], submits these comments on the Commission's Emergency Short Sale Rule 204T, and on the general approach of using buy-in rules as a means to address concerns relating to potentially abusive short selling.

Buy-In Rules Are Not the Best Approach to Address Delivery Failures. Instead, the Commission Should Set an Escalating Schedule of Fines to Be Imposed by NSCC Automatically Upon Any Failure to Deliver.

Buy-in rules raise many serious operational issues and complexities for broker dealers and regulators, therefore requiring elaborate and frequently-changing rules, exceptions, guidance, interpretations, frequently-asked questions and on and on and on.

While we understand that the Commission was required to act in unusual haste in issuing Rule 204T, the rule has suppressed stock lending across the board because the time frames for buy-ins of securities and recall notices for shares lent out are difficult to comply with and are inconsistent with prior standard practice in the industry. Many stock lending desks are in turmoil or simply shut down. Many broker-dealers and large institutional investors have sharply reduced their stock lending, which reduces their return on equity on their long stock holdings and also negatively impacts the price discovery mechanism on U.S. equity markets.

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[1] Interactive Brokers LLC ("IB") is a direct-access brokerage firm offering trading in stocks and options along with other investment products. Timber Hill LLC is a market maker in thousands of stocks and options.

In addition to the operational problems for stock lending desks caused by the new buy-in rules, the buy-in rules also result in best execution problems for customers who may get bought-in at unfair prices in markets distorted by buy-in deadlines.

A better way to approach the problem of failures to deliver would be to impose a per-share fine (*e.g.*, 10 to 100 basis points for the first day and rising by some amount for each subsequent day) for any failure to deliver. The National Securities Clearing Corporation would automatically deduct this fine from each member's account each day. The rate could be moved up or down on a daily basis to address particular issues. Revenues raised by the fines could be used to fund Commission regulatory programs or to bolster clearing houses or for other uses.

This approach would greatly simplify rulemaking and enforcement and would dramatically reduce the costs to broker-dealers to comply with, and the costs to the Commission and the SROs to enforce, complicated buy-in rules. Likewise, a clearly defined schedule of fines rather than an unpredictable and operationally complex buy-in regime would punish and discourage failures to deliver while at the same time providing clarity and certainty to stock lending operations.

Specific Operational Issues and Comments on Rule 204T:

As noted above, we think that the Commission should address failures to deliver through a schedule of escalating fines to be imposed by NSCC, rather than through a continuation of buy-in rules. However, if Rule 204T is extended further or if the Commission proposes permanent rules based on Rule 204T's buy-in approach, we suggest the following changes:

1. <u>The Buy-In Time Should Be Extended into the Morning of T+4 (e.g., 11 a.m.)</u>

DTC has extended its delivery times past regular trading hours. Therefore firms cannot know during the trading day on any given settlement date what their fail to deliver position will be. Firms only find out their exact fail to deliver position (*i.e.*, their exact buy-in requirement) well after the close.

This forces firms to complete buy-ins either in illiquid after-hours markets or using "on open" orders for T+4. These buy-ins result in artificially bad prices for customers and undermine best execution.

If buy-ins could take place in ordinary markets on the morning of T+4, this problem would be greatly reduced and customers would get better prices and would be less vulnerable to market participants who can game the system at the open.

2. <u>Buy-Ins Should Not Be Required if the Purchase Would Violate Objective Best Execution Standards. The Buy-In Period Should Be Extended in Such Cases</u>

Buy-ins mandated by Rule 204T may be at odds with best execution principles and customers may receive poor prices or be taken advantage of by market participants who know that buy-ins will be required. This was not as much a problem under Reg SHO but the very compressed buy-in deadlines of Rule 204T creates serious best execution issues.

We have observed predatory pricing in stocks subject to buy-ins, with wide spreads and small quantities quoted for such stocks. The Commission should set forth objective standards for relief from buy-in obligations (and pre-borrow penalties) based on quote width and/or quote size compared to the buy-in amount. The buy-in deadline would be extended until markets exist in which the objective best execution standards could be satisfied.

One of these objective standards should be that no buy in should be required that would violate the Three Quote Rule (FINRA Rule 2320) or similar rules for a stock in which the rule is applicable.

3. <u>Loan Recall Notices Should Be Required to Be Issued by the Morning of T+4, Not By T+2 as Specified in the Staff's Recent Guidance.</u>

Failures to deliver by settlement date (especially for long sales) are often a result of the broker-dealer having lent the shares to another broker-dealer. Typically, the broker-dealer will issue a "needback" on the morning of the settlement date of the sale, asking for the loaned shares to be returned that day. After the DTC cycle on the settlement date (now extended into the early evening on the settlement date) the lending broker-dealer will know if the loaned shares have been returned (the broker-dealer will also know whether any other activity has taken place affecting its ability to deliver shares).

Under existing practice, if the loaned shares are not returned and the shares are still required, the lending broker-dealer would issue a formal recall notice late on the settlement date, or more likely, on the morning of Settlement+1 (T+4).

The guidance issued by staff seems to require a formal recall notice to be issued on or before T+2, which compresses the ordinary cycle by 1-2 days. This creates serious operational difficulties for stock lending and borrowing desks in trying to manage their cash and positions. Issuing recall notices prior to the settlement date of the long sale often results in over-recalling of shares since it is only on the settlement date that it can be determined how many shares actually are needed. Issuing recall notices on T+1 or T+2 would also result in receipt of the shares before settlement date, which is costly and inefficient for the broker-dealer that has lent shares out. Finally, hasty recalls, over-recalls and rapid buy-ins of shares is disruptive to lenders and further discourages and disrupts their stock lending business.

Broker-dealers and other institutions with large stock holdings manage their cash and finance their operations partially through their stock lending, and the smooth of operation of this business is important to these institutions and to the securities markets as a whole . The Commission's new buy-in rules would be much less disruptive if they were in accordance with common timeframes for the issuance of recall notices (*i.e.*, by mid-morning T+4).

4. <u>Issuance of a Bona Fide Formal Recall Notice by the Morning of T+4 Should Count as a Valid Close-Out in that Amount as Long as Shares Are Delivered or Bought-in on the Recipient's Behalf by the Morning of Settlement Date+5.</u>

Under relevant stock lending rules and contracts, for recall notices issued near the close on the settlement date (T+3) or on the morning of Settlement+1 (T+4), the stock loan counterparty has until 3 p.m. three days later (Settlement+4 or T+7) to deliver shares, and only after that does the broker-dealer have the right to buy the counterparty in. Thus, in the common case where a broker-dealer's fail to deliver results from the failure of a stock loan counterparty to return loaned shares to the broker-dealer on settlement date (and a recall notice is issued), the earliest that the broker-dealer can practically buy in the shares is late in the day on Settlement+4 (T+7). This will violate rule 204(T) even under the extended buy-in deadline (T+6) for fails to deliver from long sales or bona fide market making activity.

Again, the new rule compresses the stock loan recall and delivery process by 1-2 days and has caused a great deal of turmoil in the stock lending industry. The rule should be amended to state that if a broker dealer issues a bona fide formal recall notice by the morning of T+4 for shares comprising a fail to deliver position (arising from long or short sales or market making activity), this should count as a valid closeout (and no pre-borrow penalty should apply) for those shares as long as those shares are delivered by the recipient of the recall notice or otherwise by the morning of Settlement+5, or shares are bought in on the counterparty's behalf by the morning of Settlement+5.

Respectfully submitted,

David M. Battan

cc: Robert L.D. Colby
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