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October 14, 2008

Dr. Erik Sirri
Director, Division of Trading and Markets
Securities and Exchange Commission
100 F Street, NE.
Washington, DC 20549–1090

Re: Rule 204T, Securities Exchange Act Release Nos. 58572 & 58711, File No. S7-25-08

Dear Dr. Sirri:

We are writing to comment on recently adopted Rule 204T of Regulation SHO (the "Hard T+3 Close-Out Requirement"), in order to address what we believe to be an unduly narrow limitation in the 35 day exception found in Rule 204T(a)(2) – the limitation of that exception to sales pursuant to Rule 144 under the Securities Act of 1933, as amended (the "Securities Act") – and to explain why that exception should extend to legended physical securities sold pursuant to an effective registration statement. This issue has been raised with us by clients and we have discussed the matter with Mr. Brian O'Neill of the Division of Trading and Markets, who advised us to submit this comment letter.

Background

On September 17, 2008, in an effort to address rising concerns regarding the potential impact of abusive "naked" short selling on the securities markets, the Securities and Exchange Commission (the "SEC" or the "Commission") issued an emergency order intended to strengthen investor protections against such short selling.[1] According to the press release announcing the Emergency Order, "[i]n an abusive naked short transaction, the seller doesn't actually borrow the stock, and fails to deliver it to the buyer. For this reason, naked shorting can allow manipulators to force prices down far lower than would be possible in legitimate short-selling conditions."[2] Central to this effort was the adoption, on an interim final basis, of the Hard T+3 Close-Out

[1] Securities Exchange Act Release No. 58572 (Sept. 17, 2008), 73 FR 54875 (Sept. 23, 2008) (the "Emergency Order"). This requirement was extended until 11:59 p.m. Eastern time on October 17, 2008. Securities Exchange Act Release No. 58711 (Oct. 1, 2008), 73 FR 58698 (Oct. 7, 2008) (the "Extension Order").

[2] SEC Press Release 2008-204 (Sept. 17, 2008).

Requirement, which requires a participant of a registered clearing agency (a "Participant") to deliver securities for clearance and settlement on a long or short sale in any equity security by the close of business on the transaction's settlement date (generally three days after the date of the transaction or "T+3"). Failure to satisfy this requirement results in the Participant being required to close out the fail to deliver position, either by borrowing or by purchasing like securities, no later than the beginning of regular trading hours on the next settlement day ("T+4"). Until the position is closed-out, the Participant and any broker-dealer that clears and settles trades through the Participant, may not accept or effect any further short sale orders in that security unless shares actually are borrowed prior to the sale (a "pre-borrow"). This pre-borrow penalty applies not only to short sales for the person that effected the short sale that triggered the penalty; it applies to all short sales for any customer, other broker-dealer, or proprietary account.

There are two exceptions to the Hard T+3 Close-Out Requirement. First, if a Participant can demonstrate that the fail to deliver position resulted from a long sale, the Participant is required close out the fail to deliver position by purchasing securities of like kind and quantity by no later than the beginning of regular trading hours on the *third* consecutive settlement day after settlement date (*i.e.,* T+6 rather than T+4).[3]

The second exception to the Hard T+3 Close-Out Requirement (the "35 Day Exception") is the one about which we are commenting. The 35 Day Exception provides that if a Participant has a fail to deliver position at a registered clearing agency in an equity security sold pursuant to Rule 144 under the Securities Act, it is not required to close out the position on T+4 or T+6. Instead, it must close out the position only if the securities have not been delivered for 35 consecutive settlement days after settlement date.[4] While we fully support the inclusion of the 35 Day Exception in the Hard T+3 Close-Out Requirement, we believe that it has been drafted too narrowly, and that there are other, similar circumstances, beyond sales made pursuant to Rule 144, to which the 35 Day Exception should apply. Specifically, we believe that sales of legended physical securities that have been registered for resale pursuant to the Securities Act also should be included in the 35 Day Exception.

Discussion

Generally, securities must be registered under the Securities Act in order to be sold publicly. If securities are acquired in a private transaction, *i.e.,* directly or indirectly from the issuer or an affiliate of the issuer in a transaction or chain of transactions not involving a public offering ("restricted securities"), they either must be registered before they can be resold or they must be sold pursuant to an exemption from the registration requirement. Such securities generally are held in physical certificated form, and the security certificates usually bear a printed or stamped "legend" stating that the securities have not been registered and may not be transferred except pursuant to an effective registration statement or pursuant to an applicable exemption from the registration requirements.

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[3] Rule 204T(a)(1).

[4] Rule 204T(a)(2).

Perhaps the most common method of selling restricted securities is Rule 144, which provides a "safe harbor" under which sales of restricted securities can be sold without registration under the Securities Act. If the rule's conditions are followed, the seller is deemed to have satisfied the terms of the registration exemption found in Securities Act Section 4(1) for a transaction "by a person other than an issuer, underwriter, or dealer." The 35 Day Exception recognizes that such securities generally are held in the form of physical certificates that bear a restrictive legend, and that in order to complete delivery of such securities, the shares must first be forwarded to the issuer's transfer agent, with appropriate representations and documentation, so that the transfer agent can issue unlegended ("clean") shares for delivery in completion of the transaction. That process invariably takes longer than three days.

Rule 144, however, is not the only way to sell restricted securities. Indeed, restricted securities may be registered for resale by the issuer. This is effected by means of a registration statement that permits sales to be made from time to time at the discretion of the security holder ("resale-registered securities"). Because the shares are registered, they may be sold without restrictions such as those found in Rule 144, provided that the security holder (or its broker) delivers the prospectus portion of the registration statement to the buyer or its broker or other representative. In such case, the seller is not selling pursuant to an exemption from the registration requirements of the Securities Act, but instead is selling in full compliance with those requirements. But because of the narrow way in which the 35-Day Exception is drafted, resale-registered securities are not included and thus are subject to the Hard T+3 Close-Our Requirement.

Whether restricted securities are sold under Rule 144, or sold pursuant to an effective resale registration statement, the settlement mechanics are the same, *i.e.,* delivery of the certificates to the transfer agent with appropriate documentation so that the transfer agent can provide clean shares for delivery. Yet, ironically, the seller of restricted securities sold pursuant to a resale registration statement, who has made the effort to comply with the registration requirements of the Securities Act, is at a disadvantage compared to the seller of restricted securities under the Rule 144 *exemption* from registration. In fact, under Rule 204T, the seller of legended physical shares of a highly liquid security with no excessive street-wide short interest, which have been registered for resale, will be bought in on T+4, while the holder of similar legended physical shares that sells pursuant to Rule 144 has 35 days to deliver. This cannot be the right result. There is no reason to treat the Rule 144 seller better than the seller of registered securities.

The Commission addressed a similar issue when it adopted Regulation SHO ("Reg. SHO") in 2004.[5] Rule 203(b)(2) of Reg. SHO (the "locate rule") provides that a broker or dealer may not accept or effect a short sale order in an equity security unless the broker or dealer has borrowed the security, or has entered into a bona-fide arrangement to borrow the security, or has reasonable grounds to believe that the security can be borrowed such that delivery can be made on the date that delivery is due (a "locate"). However, Rule 203(b)(2)(ii) provides an exception (the "owned securities exception") from the locate rule for "[a]ny sale of a security that a person is deemed to own" pursuant to Rule 200 of Reg. SHO, "provided that the broker or dealer has been reasonably informed that the person intends to deliver such security as soon as all

[5] Securities Exchange Act Release No. 34–50103 (July 28, 2004), 69 FR 48008 (Aug. 6, 2004) (the "Reg. SHO Adopting Release").

restrictions on delivery have been removed." The owned securities exception places an outside limit of 35 days for delivery of the clean shares, after which the broker-dealer that effected the sale must borrow or buy-in securities to complete delivery.

According to the Reg. SHO Adopting Release, the owned securities exception was adopted "for situations where a broker-dealer effects a sale on behalf of a customer that is deemed to own the security pursuant to Rule 200, although, through no fault of the customer or the broker-dealer, it is not reasonably expected that the security will be in the physical possession or control of the broker-dealer by settlement date, and is thus a 'short' sale under the marking requirements of Rule 200(g) as adopted."[6] The Adopting Release provides examples of such situations, which include "where a convertible security, option, or warrant has been tendered for conversion or exchange, but the underlying security is not reasonably expected to be received by settlement date," and "where a customer owns stock that was formerly restricted, but pursuant to Rule 144 under the Securities Act of 1933, the securities may be sold without restriction. In connection with a sale of such security, the security may not be capable of being delivered on settlement date, due to processing to remove the restricted legend."[7] However, neither the owned securities exception nor the Reg. SHO Adopting Release limits the exception's coverage to those examples.[8]

Notwithstanding the owned securities exception, a contradiction arose with respect to owned securities that also were subject to the mandatory close out requirement for "threshold securities" found in Rule 203(b)(3) of Reg. SHO.[9] Rule 203(b)(3) requires a participant of a registered clearing agency that has a fail to deliver position at a registered clearing agency in a threshold security for 13 consecutive settlement days to immediately thereafter close out the fail by purchasing like securities. Thus, where an owned security also was a threshold security, a conflict arose as to whether the position needed to be closed out after 13 days or 35 days. The response to Question 5.6 of the FAQ Release attempted to resolve this seeming disconnect by explaining that the two requirements "operate independently and concurrently" and that "if an 'owned' security is a threshold security, the security must be delivered within 35 days of the trade date, and a fail to deliver position in that security must be closed out after 13 consecutive settlement days of delivery failures."

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[6] 69 FR at 48015. Rule 200(g)(1) provides that an order to sell may be "marked 'long' only if the seller is deemed to own the security being sold pursuant to paragraphs (a) through (f) of [Rule 200] and either: (i) The security to be delivered is in the physical possession or control of the broker or dealer; or (ii) It is reasonably expected that the security will be in the physical possession or control of the broker or dealer no later than the settlement of the transaction."

[7] 69 FR at 48015 & n.71.

[8] *See also* SEC Division of Market Regulation: *Responses to Frequently Asked Questions Concerning Regulation SHO* (the "FAQ Release"), response to Question 5.6 (www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm).

[9] A threshold security is a registered equity security for which there is an aggregate fail to deliver position for five consecutive settlement days at a registered clearing agency of 10,000 shares or more, and which is equal to at least 0.5% of the issue's total shares outstanding, and that is included on a list disseminated to its members by a securities self-regulatory organization. Rule 203(c)(6).

This contradiction was partially addressed in 2007, when Rule 203(b)(3) was amended to provide an exception from the 13-day buy-in requirement for threshold securities sold pursuant to Rule 144.[10] Under this exception, the Participant must close out the fail to deliver position in the threshold security by purchasing securities of like kind and quantity immediately after the 35th settlement day if the threshold securities have not been delivered, rather than after the 13th settlement day. Unfortunately, like the 35 Day Exception in Rule 204T (and unlike the owned securities exception), the Rule 203(b)(3)(ii) exception is limited to sales under Rule 144.

In proposing the Rule 203(b)(3)(ii) exception the Commission asked whether it should be extended for any other type of securities.[11] However, as adopted, it was limited to Rule 144 sales.[12] The 2007 Adopting Release referred to comments stating that Rule 144 sales "are legitimate long sale transactions that fail to settle within the normal 3-day settlement cycle only because of the time necessary to transfer the securities," that "these types of transactions do not reflect any of the abusive short sale transactions targeted by Regulation SHO since the seller has an ownership position in the security being sold and, therefore, no incentive to depress the price of the security," and that "clearing firms may have to effect buy-ins even though the security will be available for delivery as soon as the restrictions on sale have been removed."[13] It also referred to a comment letter from the American Bar Association Section of Business Law, Committee on Federal Regulation of Securities, which said that the 35 day exception in Rule 203(b)(3) should extend to "all sellers who actually own a security and are permitted a maximum of 35 days after trade date to deliver such securities to their broker-dealer in accordance with Rule 203(b)(2)(ii) of Regulation SHO, not just owners of securities eligible for resale under Rule 144."[14] The 2007 Adopting Release does not explain why the exemption was limited to Rule 144 sales.

Rule 204T was designed to address "potentially abusive 'naked' short selling in all equity securities."[15] Sales of resale-registered securities, like sales under Rule 144, are not "naked" short sales – in fact, they are not really short sales at all. They are sales of securities that the seller actually owns. It is only because of the definitional construct of Rule 200(g) that they are treated as short sales for purposes of Reg. SHO. As with any long seller, the seller of resale-registered securities is looking for the best price and has no incentive to depress the price of the security, which is the type of activity that Rule 204T is designed to address. Moreover, in many

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[10] Rule 203(b)(3)(ii).

[11] Securities Exchange Act Release No. 54154 (July 14, 2006), 71 FR 41710, 41713 (July 21, 2006).

[12] Securities Exchange Act Release No. 56212 (Aug. 7, 2007), 72 FR 45544 (Aug. 14, 2007) (the "2007 Adopting Release").

[13] *Id.*, 72 FR at 45551 (footnotes omitted).

[14] *Id.* The Securities Industry Association also submitted a comment letter urging the Commission to extend the owned securities exception from the locate rule to sales pursuant to the mandatory close-out requirement for threshold securities, "[i]n the interest of uniformity and ease of interpretation, and in order to provide relief for all such situations where a participant's fail positions are related to circumstances outside the seller's control, and not due to any abusive activity." Letter from Ira Hammerman, General Council, Securities industry Association (Sept. 19, 2006).

[15] Extension Order, *supra* n1, 73 FR at 58698.

cases the sale involves only a portion of the security holder's total position, making it even more obvious that the security holder has no motivation to drive down the price of the security.

Consequently, the 35 Day Exception to Rule 204T should include resale-registered securities. While we agree with the ABA and SIA that the 35 day exception to the mandatory close out rule for threshold securities should have been extended to all sellers of owned securities, not just those selling pursuant to Rule 144, it is much more important to extend the 35 Day Exception in Rule 204T beyond Rule 144 sales, simply because of Rule 204T's far more expansive coverage. While Rule 203(b)(3) applies only to a small subset of equity securities that have a sufficiently large short interest to be considered threshold securities, Rule 204T applies to all equity securities. Thus, while an occasional sale of resale-registered securities might be caught up in the accelerated buy-in process under Rule 203(b)(3), *all* sales of legended physical securities pursuant to resale-registration statements will be subject to the Hard T+3 Close-Out Requirement.

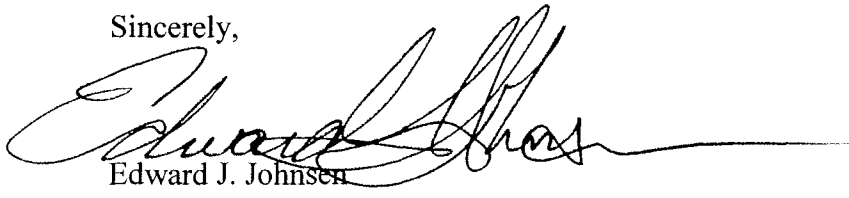
Without the change that we are recommending, virtually every sale of resale-registered securities will unfairly incur the added cost of borrowing or buying-in securities for delivery solely because the clean shares most likely will not be received from the transfer agent by T+3. We do not believe that this was the Commission's intention when it adopted Rule 204T.

Conclusion

The 35 Day Exception to the Hard T+3 Close-Out Requirement in Rule 204T should be extended to sales of resale-registered securities made pursuant to an effective resale-registration statement. These types of transactions simply do not reflect the kind of abusive short sales targeted by Rule 204T in particular, and Reg. SHO generally. The seller owns these securities and has no incentive to depress the price of the security.

Thank you for you consideration with respect to this matter. If there are any questions, or if you require any additional information with respect to the matters discussed in this letter, please contact the undersigned.

Sincerely,



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