

**Via email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov)**

December 16, 2008

Ms. Florence Harmon  
Acting Secretary  
Securities and Exchange Commission  
Station Place  
100 F Street NE  
Washington, D.C. 20549-9303

Re: File Number S7-30-08; SEC Release No. 34-58773 (October 14, 2008)  
Amendment to Regulation SHO; Interim Final Temporary Rule

Dear Ms. Harmon

NYSE Euronext and NYSE Regulation, Inc. (collectively, “NYSE Euronext”), on behalf of New York Stock Exchange LLC (“NYSE”), NYSE Arca, Inc. (“NYSE Arca”) and NYSE Alternext US LLC (“NYSE Alternext”),<sup>1</sup> submit this letter in response to the Securities and Exchange Commission’s Order Adopting Regulation SHO Interim Final Temporary Rule 204T, addressing short selling and fails to deliver (the “Order”).<sup>2</sup>

NYSE Euronext shares the Commission’s concerns about sudden and excessive fluctuations of securities prices that can result in crises of confidence in the financial health or integrity of a listed company even without a fundamental underlying basis. We agree with the Commission’s intention to limit one particular source of these declines – potentially abusive “naked” short selling – and applaud the Commission’s efforts through Regulation SHO, as well as its compliance inspections and enforcement programs, to frustrate the schemes of those who would use naked short selling to manipulate securities prices for their own benefit. Interim Final Temporary Rule 204T is a thoughtful response to the crises that the markets have experienced over the past few months, and we

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<sup>1</sup> NYSE, NYSE Arca and NYSE Alternext are each U.S. Regulated Subsidiaries of NYSE Euronext.

<sup>2</sup> Securities Exchange Act Release No. 34-58773 (October 14, 2008)



appreciate the opportunity to provide comment on the impact of the rule, offer some observations on ways the rule could be improved and seek certain clarifications.<sup>3</sup>

While we agree with the overall purpose of Rule 204T, as currently implemented it has resulted in disproportionate burdens on market makers, not in furtherance of the rule's objectives, arising out of certain anomalous trading situations. To alleviate these burdens, NYSE Euronext believes first, that Rule 204T should provide authority for self-regulatory organizations ("SRO" or collectively "SROs") to grant limited and narrowly-targeted exemptive relief from the pre-borrow requirements for designated or lead market makers on a case-by-case basis with respect to fail-to-deliver positions that develop in connection with such market maker's affirmative obligations to the exchange on which it is registered. Second, we believe that Rule 204T should contain a *de minimis* exception.

Separate from these observations on the rule, NYSE Euronext seeks clarification on certain aspects of the rule that have resulted in questions as it has been implemented over the past several weeks.

These matters are discussed more fully below.

#### 1. SROs Should Be Able to Grant Limited Exemptive Relief to Market Makers

Although Rule 204T provides a certain degree of flexibility to market makers in view of their obligation to sell to customer buy orders in a fast moving market, NYSE Euronext has found that this flexibility is not always adequate to accommodate the enhanced obligations assumed by primary market makers on NYSE, NYSE Alternext and NYSE Arca.

NYSE and NYSE Alternext Designated Market Makers ("DMM" or collectively "DMMs") are required by applicable exchange rules to maintain a two-side quotation at all times in assigned securities and, more specifically, are subject to rigorous affirmative obligations to the marketplace. NYSE Arca Lead Market Makers ("LMM" or collectively "LMMs") are similarly subject to significant performance standards beyond those applicable to other market makers. As a result, in response to market buy pressure, a DMM or LMM may effectively be required to sell short a particular security in furtherance of such obligations, notwithstanding an existing short position. Rule 204T, as implemented in the Interim Final Temporary Rule, complicates things for a market maker in that situation: in the case of a security that is relatively illiquid and hard to borrow, the DMM or LMM effectively cannot choose to withdraw from the market, but may be unable to deliver the securities in question by the T+3 settlement date or close-out an open fail-to-deliver by the open of trading on T+6 as provided by the rule.

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<sup>3</sup> NYSE Euronext's options markets are also signatories to a joint comment letter addressing options-related issues that is being submitted by the Options Clearing Corporation.



And while the rule provides some flexibility for market makers – the market maker’s clearing firm can allocate the fail-to-deliver to another broker-dealer and/or the market maker can certify to its clearing firm that it does not have a fail-to-deliver position in the security in question (i.e., that it is not responsible for the fail) – these alternatives will not necessarily enable timely resolution of all DMM and LMM fails. In practice, it can be highly disruptive to the market if the fail is not resolved by the open of trading on T+6 since the DMM or LMM in question would be unable to sell short without pre-borrowing (which is of course not realistic for a hard to borrow security), and therefore would be unable to simultaneously fulfill its market making obligations under exchange rules and comply with Rule 204T.

This possibility raises significant risks to trading on NYSE and NYSE Alternext because there is only one DMM in each security. A similar situation exists on NYSE Arca because for securities listed on NYSE Arca, there is only one LMM, which, as noted above, is subject to significant performance standards which are important to maintenance of a fair and orderly market. Because of this structure, if the DMM or LMM becomes subject to a pre-borrow restriction, there is no other similar market maker who can seamlessly step in.<sup>4</sup> Instead, the exchange must either (1) reassign the security to another DMM or LMM; or (2) in the case of NYSE and NYSE Alternext, not open the affected security for trading.<sup>5</sup>

The first approach – reassigning the security – can disrupt the marketplace since the new DMM or LMM may not be familiar with the issuer or with the trading characteristics of the security, and may therefore make an inferior market.<sup>6</sup> Moreover, the reassignment will only be temporary, since the security will be returned to the original DMM once it has closed its open fail-to-deliver position, and therefore the disruption associated with moving the security may be disproportionate to any general marketwide benefit. In

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<sup>4</sup> We note that the unresolved fail-to-deliver position may not have originated with the market maker in question. NYSE Euronext is aware of at least one instance in which a clearing firm experienced operational difficulties in allocating fails to a particular broker-dealer customer, which had the unintentional consequence of causing all customers of that clearing firm (including DMM units) to be affected. While the non-failing customers, including the DMMs, had the ability under the rule to avoid restrictions if they could certify that they had not failed to deliver, customers faced a degree of uncertainty in making that determination. The Commission should consider whether, in the case where a clearing firm is not able to allocate fails to particular broker-dealer customers, some form of additional exemptive relief would be appropriate so as not to place customers of that clearing firm at a competitive disadvantage.

<sup>5</sup> Indeed, on a number of occasions, the NYSE has been required to delay opening a security, or halt it intra-day, for an hour or more because there was not sufficient sell interest on the book at a price reasonably related to the market to enable the DMM to close out its fail position. In the case of NYSE Arca, although trading can continue such trading would be without the LMM and its price discovery and liquidity which are important to the market participants and issuers in particular.

<sup>6</sup> This is important not only for equity securities, but for securities which have derivative pricing features such as exchange traded funds, exchange traded notes, structured products, rights, corporate warrants and ADRs, all of which can require the DMM or LMM to use sophisticated algorithms and/or international market data feeds to generate appropriate market prices.



addition, the objectives of the rule may not be well served by reassigning the security since the new DMM or LMM may develop a violative fail-to-deliver within six days of such assignment. In this regard, a fail that cannot be resolved by the open of trading on T+6 will necessarily involve a hard to borrow and/or very thinly traded security. As a result, it is possible that the newly assigned DMM will similarly become unable to trade within six days of receiving the reallocated security. In effect, transferring the security may only succeed in transferring the original DMM fail-to-deliver position to the new DMM unit: once the original DMM unit is no longer the registered DMM in that security, it will close out its fail position by purchasing shares in the open market. But assuming that there are not other sellers, the new DMM would be forced by its affirmative obligation to sell short to the original DMM, even though the new DMM may not be able to close out the position by T+6. Thus, the original fail-to-deliver position simply moves from one DMM to another.

The latter approach – not opening the security for trading – could harm the public interest and investors. First, halting trading in the primary listing market reduces liquidity for an already illiquid security, possibly depriving shareholders and potential investors of the opportunity to trade at competitive prices. Second, halting such securities could cause disruptions for indices and derivatives thereof that are priced and valued based on primary market prices.

In addition to the public policy considerations described above, the Commission should also consider the operational limitations on reassigning securities, namely that it is not technologically possible to reassign a security from one DMM or LMM to another intra-day, since the necessary programming changes can only be done overnight. As a result, although under Rule 204T DMMs and LMMs have until the beginning of trading on T+6 to close out a fail, these systems limitations on the various markets mean that they effectively have only until T+5 to advise the relevant exchange whether they have resolved an open fail position that would otherwise prevent them from trading on T+6, in order to give the exchange enough time to reassign the security to a different DMM or LMM if necessary.<sup>7</sup> Thus, although the Commission's intent under the rule was to give market makers until T+6 to resolve open fails-to-deliver, practically speaking, they do not have available to them the amount of time contemplated.

To resolve these public policy and operational issues, NYSE Euronext proposes two modifications to the rule:

*First*, the Commission should amend Rule 204T to give SROs limited exemptive authority to grant designated or lead market makers appropriate extensions of time to close out fail-to-deliver positions. Extensions would be granted on a case-by-case basis by the SRO's regulatory staff, based on certification by the DMM or LMM that it

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<sup>7</sup> We also note that DMMs and LMMs must rely on clearing firms to provide timely and accurate data regarding open fails. If a clearing firm were unable to do so, the impact of that failure would fall on the DMM or LMM and on the exchanges.



established the short position solely as a result of *bona fide* market making activity, and undertook reasonable efforts to close out the fail-to-deliver prior to seeking relief. The SRO's regulatory staff would also take into consideration instances where a clearing firm was unable to provide timely or accurate data. All requests for relief would require proper documentation by the DMM or LMM and would be subject to comprehensive assessment by the SRO's regulatory staff subsequent to granting the extension as to the reasonableness of the certification, as well as review by the Commission staff.<sup>8</sup>

We note that the Commission has previously given SROs authority under Regulation SHO to approve requests for extensions of the cover and pre-borrow requirements by specialist member organizations for threshold securities. In 2005, the NYSE and the American Stock Exchange (now NYSE Alternext) received authority to approve requests for extensions of the cover and pre-borrow requirements, in view of the unique and critical role of such specialists to the market in their assigned securities. In support of this authority, the exchanges developed an extension request process, pursuant to which specialists were required to set forth the reasons and circumstances for the short fail to deliver position, efforts taken prior to the request to close the fail and the time they estimated it would take to cure the short position. If the relevant exchange and the Commission staff both approved the extension request, the specialist was afforded an appropriate extension to resolve the position. This process was utilized periodically to provide extensions to specialists of exchange traded notes, closed-end funds, preferred stocks and warrants, which tend to be extremely illiquid.

NYSE Euronext believes that application of the extension process to DMMs (who now act in a role that is similar to the former specialists) and LMMs who are unable to close a fail in an assigned security by the open of trading on T+6, as required by Rule 204T, would enable the exchanges to more effectively manage the operational issues described above. NYSE Regulation staff would be charged with review of any extension requests and would assess the reasons and circumstances for the fail, whether the DMM or LMM took appropriate efforts to close the fail prior to seeking relief and whether the length of the extension requested appeared to be reasonable in view of its size and the typical trading characteristics of the security in question.<sup>9</sup> Additionally, while the threshold security process was generally limited to exchange traded notes and other non-equity securities, NYSE Euronext believes it is necessary to provide for the possibility of extension relief for all securities (including equities and exchange traded funds<sup>10</sup>) under

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<sup>8</sup> Generally, given the short time frames provided by Rule 204T compared to the Regulation SHO rules governing threshold security fails, regulatory staff will be unable to comprehensively assess the reasonableness of a certification prior to granting a limited extension. However, a pattern and practice of submitting unwarranted certifications would result in denial of future extension requests as well as disciplinary action if warranted.

<sup>9</sup> As noted in footnote 8 *infra*, such review would generally be performed on an after the fact basis.

<sup>10</sup> While most exchange traded fund fails can be resolved by the creation of additional units of the fund, in some cases the fail amount is smaller than the minimum creation size, so that creation is not necessarily an economically viable option.



appropriate circumstances, in view of the much shorter time frames Rule 204T provides for resolution of a fail to deliver. Specifically, the 13-day time period provided to resolve a fail in a threshold security was generally adequate, in the case of all but the most illiquid non-equity securities, for clearing firms to allocate the fail and for the specialist firm to take action to buy or borrow the security in question. By contrast, Rule 204T provides only two days, plus the pre-open period on T+6 following a T+3 fail.

In addition, the SRO should have authority to continue trading notwithstanding intra-day notification that a DMM or LMM has become subject to the borrowing requirement to avoid a market disruption and enable an order reallocation for the following day.

*Second*, the Commission should extend the market maker close-out deadline to the close of the regular trading session on T+6. This would give a DMM or LMM the full time period intended under the rule to determine definitively if it is able to close out its fail-to-deliver position and would enable the relevant exchange, where necessary, to reallocate the security to another DMM unit or LMM without unduly disrupting the market.<sup>11</sup>

Extending the close-out deadline to the end of the trading day would also enable DMMs and LMMs to use volume weighted average price orders entered at the beginning of T+6, to more effectively manage their buy-in risk.

## 2. Rule 204T Should Include a *De Minimis* Fail Exception

NYSE Euronext also believes that it would be consistent with the intent of the rule to include a *de minimis* fail exception to the close-out requirement. Under such an exception, fails-to-deliver that did not exceed the minimum limit would not be violative of the rule or trigger its remedial provisions. Based on anecdotal statistical information collected by DMMs, NYSE Euronext believes that the implementation of a *de minimis* exception would greatly reduce the number fails triggering the pre-borrow penalty of Rule 204T. We would be pleased to provide additional statistical analysis to identify the appropriate *de minimis* level.

We note that on the NYSE and NYSE Alternext, *de minimis* fail positions are particularly likely to occur in connection with odd lot trading. By operation of NYSE and NYSE Alternext rules, odd lot executions take place automatically, with the DMM acting as the contra-side to all odd lot trades. As a result, DMMs may sell short in a *de minimis* amount automatically and without prior knowledge. If the odd lot trade occurs in a hard-to-borrow or illiquid securities, the DMM may not be able to avoid failing to deliver.

NYSE Euronext does not believe that permitting a *de minimis* fail, particularly in less-than-round lot amounts, would undermine the intent of the rule or materially increase the

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<sup>11</sup> While this letter addresses issues related to NYSE Euronext's exchange market makers, we would also support a similar provision for all market participants in order to eliminate price dislocations at the opening of trading.



harm that it was intended to address. Such fails are insignificant to the average daily volume traded in all but a handful of securities, and unlikely to be the result of the types of manipulative naked short selling that Rule 204T was designed to address. Moreover, the cost of such a *de minimis* exception is itself minimal compared to the costs to the larger market that could result if a single fail for a small number of shares prevents a significant broker-dealer from selling short.

### 3. Rule 204T Should Allow Greater Flexibility to Meet the Close-Out Requirement

Other commenters have noted that Rule 204T has resulted in some contraction in broker-dealers' stock lending activities which has reduced cash liquidity to broker-dealers as an alternative to reduced or "frozen" bank lending. NYSE Euronext recommends that the Commission consider adopting operational changes to Rule 204T to address these concerns, including but not limited to, allowing a *bona fide* recall and/or borrowing of securities to constitute a close-out of a fail-to-deliver position.

### 4. Miscellaneous Clarifications Sought

In addition to the foregoing, NYSE Euronext requests that the Commission provide clarification on the following:

- Rule 204T refers to "the beginning of regular trading hours" on either T+4 or T+6 as the deadline for closing out fails to deliver. We request that the Commission clarify that the phrase "beginning of regular trading hours" means the opening trade on the listing or other market, even if that opening takes place after the beginning of regular trading hours, rather than the first trade of the day on T+4 or T+6 (regardless of whether it is on the listing market or not). We believe that it is appropriate to permit such fails to be closed on, or contemporaneously with, the opening trade on the listing or primary market. This interpretation would contribute to a more transparent, fair and orderly market, since market participants could utilize the opening processes in place at the various listing and other markets which enable the broadest possible price discovery and participation compared to the pre-opening markets.
- We also request that the Commission provide that participants be able to satisfy the close out requirement by entering a volume weighted average price order at the opening on T+4 or T+6, in an amount equal to or greater than the fail amount, at a price reasonably related to the market. As noted previously, this would help participants manage their buy-in exposure, which could help avoid unnecessary price dislocation on the morning of T+4 or T+6 (as applicable). NYSE Euronext believes that this approach would be consistent with the intent of Rule 204T and should be permitted.



- We further ask the Commission to clarify that a clearing firm is required to notify other broker-dealer customers of the allocation of the fail to a particular broker-dealer customer. Rule 204T(d) provides that a clearing firm may allocate a portion of a fail-to-deliver position to another registered broker-dealer for which it clears trades or from which it receives trades for settlement. This rule adds an additional notification requirement, in that a broker-dealer that has been allocated a portion of a fail-to-deliver position that does not comply with the provisions of Rule 204T(a) must immediately notify the participant that has become subject to the borrowing requirements of Rule 204T(b). We believe that placing an additional notification requirement on the clearing firm is consistent with the overall approach of Rule 204T and would reduce confusion among broker-dealers. In addition, we believe that if a broker-dealer acting as a market maker becomes subject to such borrowing requirements, the broker-dealer and its clearing firm should be required to notify the primary market on which it acts as a market maker in the security in question.

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If you have any questions regarding the foregoing, please feel free to contact Claudia Crowley, Senior Vice President, NYSE Regulation, at (212) 656-4631; Daniel Labovitz, Vice President, NYSE Regulation, at (212) 656-2081 or Karen Lorentz, Managing Director, Market Operations, at (212) 656-5858.

Sincerely yours,

Duncan L. Niederauer  
Chief Executive Officer  
NYSE Euronext

Richard G. Ketchum  
Chief Executive Officer  
NYSE Regulation, Inc.

cc: Chairman Christopher Cox  
Commissioner Kathleen L. Casey  
Commissioner Elisse B. Walter  
Commissioner Luis A. Aguilar  
Commissioner Troy A. Paredes  
Erik Sirri, Director, SEC Division of Trading and Markets  
Robert L.D. Colby, Deputy Director, Division of Trading and Markets  
James A. Brigagliano, Associate Director, Division of Trading and Markets