



The Security Traders Association of New York, Inc.

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October 13, 2009

The Honorable Mary L. Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549

**Re: Responses to Frequently Asked Questions (FAQs) on Regulation SHO –
August 28, 2009 - FAQs 2.4 and 2.5**

Dear Chairman Schapiro:

The Security Traders Association of New York, Inc. (“STANY”) is writing in response to the recent on-line publication of interpretations of Regulation SHO (“Reg. SHO”) under the Securities and Exchange Act of 1934 (the “Exchange Act”) by the Staff of the Securities and Exchange Commission’s (“SEC” or “Commission”) Division of Trading and Markets (“the staff”). Specifically we wish to address FAQs 2.4 and 2.5 which the staff added on August 28, 2009.¹

The Security Traders Association of New York is the voice of the trader in the New York metropolitan area. STANY represents approximately 1,200 individuals at over 250 firms, all engaged in the buying, selling and trading of securities. As such, we are uniquely qualified to discuss rules and regulations affecting the purchase and sale of securities.²

¹ Responses to Frequently Asked Questions Concerning Regulation SHO. See <http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm>. The text of FAQs 2.4 and 2.5 is annexed hereto.

² STANY is the largest affiliate of the Security Traders Association (“STA”), a multinational professional trade organization that works to improve the ethics, business standards and working environments of its members. Neither STA, nor STANY, represent a single business or business model, but rather provide a forum for traders representing institutions, broker-dealers, ECNs, ATNs and floor brokers to share their unique perspectives on issues facing the securities markets. Our members work together to promote their shared interest in efficient, liquid markets, as well as their concern for investor protection. We believe that strong and efficient markets require an appropriate balance between effective regulation and innovation and competition.

Background

On August 28, 2009, the staff issued two new interpretations concerning the methodology for marking orders “long” or “short” under Reg. SHO. The new interpretations have been met with concern by our members because, in response to both questions, the staff articulated views of broker-dealer obligations under Reg. SHO that differ materially from the common understanding and practice of industry participants. In fact, the staff’s interpretations create new requirements for order marking. These requirements were not addressed in Reg. SHO and impose substantial compliance obligations on the securities industry. The staff’s interpretation will require firms to implement costly system changes to accommodate these new obligations without the benefit of an implementation timeframe typical of new regulation.

Given the significant departure from long standing practice which the staff’s interpretations represent, we respectfully request that the Commission direct the staff to withdraw the relevant FAQs. If the staff and Commission believe that the newly imposed requirements in the FAQs are advisable and consistent with the Commission’s charge under the Exchange Act, we believe the appropriate action would be for the Commission to undertake rulemaking with respect to these requirements and provide notice and the opportunity for public comment. Subjecting the interpretations to the standard rulemaking process will allow the Commission the opportunity to consider potential consequences of the rule changes and provide guidance to market participants about key aspects of the requirements that have caused confusion. It will also allow firms the opportunity to re-program their systems with a full understanding of what changes will be needed to be in compliance with the new requirements.

FAQ 2.4 Order Splitting

FAQ 2.4 deals with the methodology by which a broker dealer marks an order where the seller is net long for only a portion of the order. Under the new FAQ requirement, if a seller is net long 500 shares of a security but wishes to sell a total of 600 shares of that security, only 500 shares can be marked “long” and the remaining 100 shares must be marked “short.” The original order to sell 600 shares must be split into two orders under the FAQ.

This interpretation differs dramatically from the understanding and practice in the industry. Prior to publication of FAQs 2.4 on August 28, 2009, it was common practice to not split orders in the above scenario, but rather firms took a more conservative approach and would mark the entire sell order “short” when the order size was greater than the firms’ net long position.

This practice was consistent with guidance provided by self-regulatory organizations (“SROs”). For example, the practice is consistent with the Financial Industry Regulatory Authority’s (“FINRA”) (f/k/a National Association of Securities Dealers (“NASD”)) interpretation of the order marking provision of its short sale rule whereby firms could elect to split an order or mark the entire sell order “short” when the order size was greater than the firm’s net long position at the time of order entry.³ Either practice was acceptable.

Notice to Members 94-68, Question 21, upon which members have relied, states:

If a member is long 500 shares and wants to sell 600 shares, the firm may treat this either as a long sale for 500 and a short sale for 100 (two reports), or may mark the entire order as a short sale.

We recognize that this guidance from FINRA was issued in connection with the former NASD short sale rule and not Reg. SHO. However, in the absence of contrary guidance, firms have understood the practice of marking an entire order “short” under these circumstances to be acceptable. There is nothing in Regulation SHO that would indicate that the requirement for order marking changed with the approval of SEC Rule 200 of Regulation SHO, nor was the requirement to split orders articulated in any of the Commission’s proposals or adopting releases concerning Regulation SHO.

Therefore, it is entirely reasonable to expect that firms would continue to mark orders as they have been doing. This is especially true since this method of making orders is consistent with the regulatory objectives articulated in Reg. SHO of reducing failures to deliver and eliminating abusive “naked” short selling. The guidance provided by the NASD in Notice to Members 94-68 allows a conservative approach to making orders “short.” If a firm elects to mark an entire order “short”, the entire order would be subject to the shorter timeframes for close-outs under SEC Rule 204 as well as the locate requirements of Rule 203. Furthermore, the entire order would be subject to any price test which the Commission may determine to reinstate.

Given the long established practice of making orders “short” in accordance with the NASD’s guidance and the fact that that guidance appears to be consistent with the objectives of Reg. SHO, the staff’s response in FAQ 2.4 came as a surprise to industry

³ See 94-68 SEC Approves Short-Sale Rule for The Nasdaq Stock Market, Question #21. While we understand that the NASD’s interpretation applied to its short sale rule which was in place prior to Reg. SHO, the guidance specifically addressed making of orders (as opposed to a bid test) and has been relied upon by members of FINRA since 1994.

participants. The staff's interpretation and implication that the practice of marking the entire order "short" is inappropriate is the first and, as far as we know, only written indication that firms must split orders in the described scenario.

FAQ 2.4 also raises concerns about investor protection. We fear the new mandate to split orders could cause customers to receive inferior prices than they would have received with the submission of a single order. We anticipate that the new requirement to split orders for order marking will create significant additional odd-lot orders. Not only are odd-lot orders excepted from the trade-through protections of Reg. NMS, but exchanges have the right to choose whether to accept odd-lot orders. Sending inter-market sweep orders becomes complicated with order splitting, especially when a trading center is unwilling to accept odd-lots or mixed lot portions of round lot orders.

Our members are also concerned that new FAQ 2.4 has created the need for significant changes to existing systems and processes. Implementing the capability to split orders impacts various systems within a firm and requires technical changes to front-end systems, gateways, regulatory reporting systems and related systems. Changing the "one order placed, one order sent", model upon which many trading platforms are built is a significant undertaking, further complicated by cancel features, such as "cancel/replace" that many firms have included in their systems. These changes will be costly and time consuming without offering any material positive impact to the markets. The net result for exchanges will be a significant increase in order messaging and a reduction in execution quality.

FAQ 2.5 What Constitutes a "Short" Sale

The staff's interpretation in FAQ 2.5 is equally troubling for the industry. In FAQ 2.5 the staff directs firms to include all pending offers in calculating a firm's position for marking purposes. Thus a firm would be required to calculate its "long" and "short" marking based on the total of its inventory plus all pending but unexecuted offers.

This is a significant departure from industry practice whereby firms have updated their inventory positions upon an order's execution, whether such order is a buy or sell order. It is important to note that this approach has been the subject of years of unquestioned regulatory oversight and has been supported by NASDAQ.⁴ As with FAQ 2.4, Reg. SHO and the Commission have both been silent on this issue, therefore it is reasonable to expect that broker-dealers, in the absence of any statements countermanding the

⁴ See NASDAQ Equity Trader Alert 97-38 which articulated a position that has become standard practice for broker-dealers and which is contrary to the position now articulated by the staff in FAQ 2.5.

NASDAQ's directive, would continue to mark their orders based on their actual positions.

Not all offers result in executions nor are all offers marketable when entered. Requiring firms to include all pending offers in the "long" and "short" marking fundamentally changes the definition of "short sale." Marking orders "short" is no longer based on a firm's actual position. Rather, FAQ 2.5 mandates that firms count sell orders against their positions despite the fact that firms still retain the rights as holders of the security.

Our members are concerned that this approach will dramatically increase short sale reporting. Many firms acting as market makers actively place orders on both sides of the market throughout the day and cancel and replace orders as the market moves. A much smaller number of orders are actually executed than are entered. Counting all sell orders against a firm's position could easily lead to a situation wherein all or almost all of a firm's sales will be required to be marked short, even if the firm does not have an actual short position intra-day.

We are concerned that the artificial inflation of "short sales" resulting from FAQ 2.5 will (1) require firms to locate more stock than they actually require and possibly make liquid, easy to borrow stocks hard to locate, (2) materially impair firms' abilities to provide liquidity, (3) significantly distort the daily transactional short sale data being provided by the exchanges thereby creating the false impression that short selling activity has increased significantly and (4) compromise efforts to monitor short selling and enforce measures to prevent abuses. We are concerned that these likely consequences of the staff's newly imposed requirements have not been fully considered. We are also concerned that should the Commission determine to reinstate a price test, the consequences of these artificially inflated short positions would be even more significant.

Likewise, many of the implementation issues raised with respect to FAQ 2.4 above also apply to FAQ 2.5 which will similarly require significant re-programming of firms' systems. Systems which have been tracking actual inventory now need to track the amount of all pending offers, including cancellations and executions, to determine "inventory" for purposes of marking positions. Since trading firms typically send orders to multiple venues in multiple locations with different latencies and non-sequential reporting; collection and management of pending order data is an extremely challenging undertaking. It is infinitely more difficult to require firms to calculate a position based on pending sell orders in the market at any given time than to monitor actual changes to inventory resulting from executions.

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Conclusion

Both FAQs 2.4 and 2.5 represent significant departures from industry understanding and practice based on guidance issued by SROs. They create new requirements under Regulation SHO and are not merely clarifications of existing obligations. We are concerned that the implications and potential unintended consequences of FAQs 2.4 and 2.5, have not been fully evaluated, nor has the staff articulated a compelling rationale for adopting these changes. These new requirements will necessitate significant modifications to firms' order management systems and short sale locate procedures, distort short sale reporting data, negatively impact market quality and protections offered to investors and materially change the scope of proposed short sale regulations under consideration by the Commission.

These FAQs should have been subject to the Commission's review as well as to notice and comment through the rulemaking process prior to becoming effective. STANY respectfully requests that the Commission instruct the staff to withdraw FAQ 2.4 and 2.5 and that any new requirements contained therein be subject to standard rulemaking complete with notice and comment.

Please do not hesitate to contact STANY if you have any questions.

Sincerely,

Kimberly Unger
Executive Director
STANY

The Hon. Kathleen L. Casey, Commissioner
The Hon. Elisse B. Walter, Commissioner
The Hon. Luis A. Aguilar, Commissioner
The Hon. Troy A. Paredes, Commissioner
James Brigagliano, Co-Acting Director, Division of Trading and Markets
Josephine Tao, Assistant Director, Division of Trading and Markets

Attachment

SEC Staff Responses to Frequently Asked Questions
Concerning Regulation SHO

Question 2.4: How should a broker-dealer mark an order where the seller is net long for only part of the order?

Answer: A seller may be net long a security but wish to sell additional shares of that security in excess of the seller's net long position. For example, a seller may be net long 500 shares of a security but may wish to sell a total of 600 shares of that security. Under such circumstances, only 500 shares can be sold long, and the remaining 100 shares must be sold short.

Rule 200(g) of Regulation SHO requires a broker-dealer to mark sell orders in any equity security as "long" or "short." Rule 200(a) defines a short sale as "any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller." Rule 200(g)(1) provides that "[a]n order to sell shall be marked "long" only if the seller is deemed to own the security being sold pursuant to paragraphs (a) through (f) of this section 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." Rule 200(c) of Regulation SHO provides that a person shall be deemed to own securities only to the extent that he has a net long position in such securities. In addition, to determine its own net position, Rule 200(f) requires a broker-dealer to aggregate all of its positions in a security unless it qualifies for independent trading unit aggregation.

Thus, under the above-mentioned scenario, if the seller is long 500 shares, the sell order for the sale of such 500 long shares must be marked "long" and the sell order for the sale of the additional 100 shares must be marked "short."

Furthermore, Rule 17a-3 requires, in part, that "[e]very member of a national securities exchange who transacts a business in securities shall make and keep current...books and records relating to its business" including a memorandum of each order which shall show the terms and conditions of the order or instructions. The memorandum must include accurate terms and conditions of the order. Thus, the order must be marked to accurately reflect that part of the order is long and part of the order is short.

Question 2.5: How should a broker-dealer mark an order where the seller is net long 1,000 shares and wants to simultaneously enter multiple orders to sell 1,000 shares each?

Answer: Rule 200(g)(1) of Regulation SHO states that "[a]n order to sell shall be marked "long" only if the seller is deemed to own the security being sold pursuant to paragraphs (a) through (f) of this section 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." Further, Rule 200(c) of Regulation SHO provides that a person shall be deemed to own securities only to the extent that he has a net long position in such securities.

Thus, we remind sellers that where a seller is net long 1,000 shares and simultaneously enters multiple orders to sell 1,000 shares owned, only one such order would constitute a long sale. After the long sale order is entered to sell the 1,000 shares, it is no longer reasonable to expect that delivery can be made by settlement date on additional orders to sell the same shares. In addition, under Rule 200(g)(1) of Regulation SHO, a broker-dealer must mark only one order as "long" and any additional orders as "short."