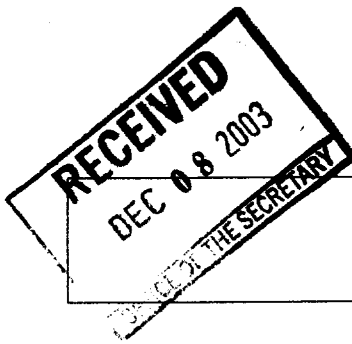

11/30/2003

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SEC
Comments Ref. S7-23-03

To The Commission & The Concerned Public:

I write from the perspective of one who has spent twenty years in the securities industry. My career started in operations for an arbitrage firm on the CBOE, then as a market maker on the PSE, and then as a partner within a major broker dealer specialist firm. I have experience as a principal buying and selling shares in public companies numbering in the hundreds of millions. I have extensive experience in shorting stocks and in issues involving settlement.

I've reviewed proposed rule changes published 11/1/03, as well as some of the many comments available on the SEC site, and I feel compelled to caution The Commission that it may be unduly influenced by lobbyists to write new rules that will damage our markets in a variety of ways. Some of the lobbyists aim to increase the abilities of public corporations to access equity markets at favorable rates (i.e. high stock prices). Others simply seek control of a very lucrative form of currency, that is the shares of common stock, traded in the public markets. They want to be in a position to arbitrarily hold up certain share prices, effectively leveraging investment banking and the creation of wealth through shares of common stock. But the control they seek will damage the public's faith in common stock shares as a measure of value, and these shares comprise a large portion of our wealth as citizens of the United States.

The market has evolved in significant ways since 1934 and it is understandable that The Commission seeks to modify rules regarding short selling. The elimination of the downtick rule on selected stocks is a worthy experiment and will probably lead to better markets for the public. However, the proposed changes to delivery requirements are ill conceived. The arguments for these proposals are simply contrary to the best interests of the public. The Commission should instead focus on developing rules and systems that protect the rights of buyers. Ironically, this may make short selling easier by making clearance, and particularly delivery requirements, a less cumbersome process. And, although the public has been damaged far more by strategies manipulating stock prices upward, The Commission should also seek to develop new rules and penalties that address manipulative strategies that employ short selling. The Commission should not alter the rules to restrict short selling because such alterations will damage the market more than they will improve it.

My comments demonstrating this view will first be addressed towards specific questions asked by The Commission in Part II C., and then summarized afterwards.

Q. What harms result from naked short selling? Conversely, what benefits accrue from naked short selling?
A. Some publicly traded companies experience more selling pressure as a result of naked short selling than they might otherwise.?If there is negative news of some sort, perhaps information concerning a toxic (death spiral) financing agreement, increased selling pressure can be extreme. Since toxic financing arrangements have caused such damage recently, most CFOs are wise enough to avoid them or to render them harmless with simple modifications to their financing agreements. Naked short selling, however, still harms companies effected by negative sentiment either by inhibiting the rise of stock prices or by depressing stock prices and, presumably, limiting financing ability, and hence growth.
Also, naked short selling causes lost revenue to the small number of major brokerage houses controlling the supply of borrowable stock that could otherwise extract a price from short sellers. In addition, naked short selling creates extra back office work for these firms as delivery problems are dealt with, or when voting or tax issues arise.

On the plus side, naked short selling creates more liquid markets, and lower prices for the public prepared to buy. Consequently, educated buyers with cash reserves are more often rewarded. There are also fewer instances where the public gets burned because there are fewer instances where stocks attain inflated value. Of course, naked short sellers increase the number of participants in the markets, and their presence creates more information available for the public to base its decisions on. Lower prices caused by naked short sellers frequently prompt development of public debate and corresponding disclosure as they did during the downward price moves in companies like Enron, Tyco, and Worldcom. Naked short sellers also prevent the monopolization of short selling by engaging in such activity without the permission of the suppliers. This activity is a highly valuable form of instant liquidity, de facto market making, at a time when information is wanting. Since current rules in effect expose naked short sellers to significant risks, their presence is usually indicative of extreme inefficiencies in the market. Naked short sellers are quite often sellers of "last resort" in the market. On a side note, naked short selling also produces interest income to brokerage houses that retain funds internally after debiting customers immediately for stock purchases not delivered upon, a practice which has caused many brokerages on the buy side to tacitly allow fails to receive.

Q. Are there negative tax consequences associated with naked short selling, in terms of dividends paid or otherwise?
A. There is administrative difficulty in assigning tax liability associated with dividends, rights, or special taxable distributions which brokerage firms can usually assign eventually to the failing short seller. There are cases when such assignments can take years to settle however. When such liabilities exist, setting margin requirements, or closing accounts can become a problem for clearing firms. The DTC clearing system, as it now, makes such assignments especially difficult but could be easily modified to "fix" liabilities for existing fails at prescribed times to properly account for tax. The

assignment process could be designed similar to option assignment allocation at the occ.

Q. What is the appropriate manner by which short sellers can comply with the requirement to have "reasonable grounds" to believe that securities sold short could be borrowed? Should short sellers be permitted to rely on blanket assurances that stock is available? Is the equity market transparent enough to allow efficient means of creating these lists?
A. "Reasonable grounds" for locate belief could well rely on general lists currently available at most brokerage houses, i.e. "hard to borrow" or "easy to borrow". The problem is there is no appropriate manner for short sellers to have reasonable grounds to always have a short position covered with borrowed stock. Because borrowed stock can be recalled at any time at the owner's request, all short sellers including the naked, even if allowed to rely initially on such lists, have always been highly vulnerable to changing or, worse, manipulation of supply. The mandatory actions backing up failures will render any contemplated list irrelevant. Most short sellers, and particularly market makers, will not be able to bear the risk of mandatory recall or fines and will exit the market.

Q. Should short sales affected by a market maker in connection with bona fide market making be exempted from the proposed "locate" requirements? Should exceptions be tied to certain qualifications or conditions? If so, what should these qualifications be?
A. Some sort of exception for market makers must be in place in order to lessen the risk of being in that business. Having been a market maker for many years I can say that obligations, particularly the mandatory liquidity requirements of market makers, will be impossible to fulfill without subjecting the practice to extreme financial risk. I will cease to make markets in a variety of financial instruments, and I will not function as a guarantor to many others who make their living this way, if hindered by complicated locate rules or subjected to mandatory recalls. I can only assume that most others in my position would do the same. Such requirements to locate shares, or draconian penalties for fails to deliver, will obliterate market making on many exchanges. Many will lose their jobs. Liquidity in any "hard to borrow issue" will be completely limited to a select few market makers beholden to their suppliers. If The Commission continues to allow market makers an exception to locate and deliver shares, the system could be improved by limiting the number of shares so exempted by a formula related to bona fide hedges, such as the cumulative number of option or warrants held, or underlying convertibility of other instruments. The market making community, unlike the variability of supply and demand of common stock, which is for the most part opaque, could easily manage these formulas. This exemption would not, however, address the risk imposed upon market makers by mandatory recalls.

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Q. Should the proposed additional delivery requirements be limited to securities in which there are significant failures to deliver? If so, is the proposed threshold an accurate indication of securities with excessive fails to deliver? Should it be higher or lower? Should additional criteria be used?
A. The additional delivery requirements for selected securities contemplated are likely to be very cumbersome. If The Commission is set on establishing these requirements, better to impose them for the smallest number of stocks possible. However, trying to classify any stock that has significant fails to deliver is impractical. Typically the failures to deliver increase dramatically during brief times surrounding certain events and are too difficult to predict. And what can be deemed excessive is very subjective. In other words, failures to deliver, in many situations, can be termed excessive. In other situations, say because of merger, the same number of failures should be expected and not deemed "excessive". Failures in many situations are very helpful to fair and orderly markets. Arbitrary thresholds are not appropriate. Additional criteria could be used but would be exceedingly complicated and would subject regulators to interpretive difficulties. Bottom line: Classification of stocks with "significant failures" is untenable and impractical.

Q. Are the proposed consequences for failing to deliver securities appropriate and effective measures to address the abuses in naked short selling? If not, why not? What other measures would be effective? Should broker-dealers buying on behalf of customers be obliged to effect a buy-in for aged fails?
A. The proposed consequences will definitely stop naked short selling. But they are not appropriate because they will subject the majority of the professional and public short sellers to undue risk, thereby eliminating important balancing factors in a well functioning market. I think the evidence shows that naked short selling in itself is not abusive -- Manipulative strategies that sometimes employ naked short selling are. The Commission should address itself to better policing the market for strategies designed to unfairly take advantage of the public or company officials by manipulating the market up or down. Stiffer penalties for well-defined abuses in these areas would improve the market and stop some naked short selling. The end of naked short selling should not be the goal. The end of market abuses, be it through short selling or otherwise, should be thd goal. Therefore, The Commission should not oblige broker-dealers to buy-in aged fails because doing so would only address naked short selling and not address market abuses directly. Obligating broker-dealers to buy-in aged fails would also destroy the ability of market makers and the public to participate in the market when there are sudden lapses in the availability of shares to borrow. In the vast majority of situations, ample remedies exist to protect the rights of buyers not receiving shares. Granted, modifications do need to be made at DTC in instances where voting is an issue because the lost right to vote cannot be monetarily addressed. Perhaps The Commission could establish corporate web sites that could serve to register voters for corporate governance and to provide the public with required filings, annual reports, etc. This would greatly reduce the waste associated with the mountain of printed reports that quite often are never sead. At these company managed sites (SEC monitored), if the number of registered voters begin to wield more voting power than shares issued allow, then mandatory recalls

could be initiated. If this were the threshold level, very few recalls would ever occur. The Commission should seek to develop methods such as this to insure the rights of ownership without establishing risky new rules that could negatively affect proper price discovery and faith in the markets. A simple system where delivery is unnecessary for buyers to have all their rights would never need brokers to execute buy-ins.

Q. Is the restriction preventing a broker-dealer, for a period of 90 calendar days, from executing sales in a particular security for his own account or the account of the person for whose account the failure to deliver occurred without having pre-borrowed the securities an appropriate and effective measure to address the abuses in naked short selling? Should this restriction apply to all short sales by the broker-dealer in this particular security? Should the restriction also apply to all further short sales by the person whose account the failure to deliver occurred, effected by any broker-dealer?
A. The obligation to obtain "affirmative determination" has always been borne by the broker dealer. Trying to follow a customer from firm to firm is impractical and too difficult to police. The broker dealer should be required to monitor the short selling of its customers the same way it monitors margins. The broker dealer may have trouble relying on other broker dealers for making firm commitments to lend shares T+3 and therefore those without in house supply sources will be at a disadvantage because they will lack the flexibility to deliver that they have now. In addition, most brokers will need to develop systems that suddenly restrict share selling in certain issues if those issues suddenly become hard to borrow. There could well be instances where supplies dry up so quickly that undeserved infractions occur. Perhaps penalties should be withheld in cases where shares suddenly become hard to borrow. Any penalty should be imposed on the broker, and not the customer however. And reneging on a commitment to lend between broker dealers should invoke the same penalty. That being said, suppliers will no doubt be in a position to charge for lending commitments, but even they will be vulnerable if shares thought to be available are suddenly sold by the owner. Although some will be in a position to earn fees from taking a chance (regulatory arbitrage), none will be in a position to absolutely insure delivery. Therein lies the contradiction of these rules and penalties: In order to insure good delivery of shares sold, current holders must have their shares marginalized to some degree. As long as short selling in any form is allowed, The Commission will be unable to address infractions properly with the proposed penalties.

Q. Should short sales effected by a market maker in connection with bona-fide market making be exempted from proposed delivery requirements targeted at securities in which there are significant failures to deliver? If so, what reasons support such an exemption, and how should bona-fide market making be identified?
A. The fact that bona-fide market making requires hedging is undeniable. Since such activity obligates market makers to take risk on the long side of the market at a moments notice, and since that risk frequently lasts for extended periods of time (e.g. short puts), it is unreasonable to require delivery when it may be impossible. "One sided" markets are not allowed, so failures must be allowed for bona-fide market making. Yet, market makers should not be in a position to leverage failures unreasonably. Exempted delivery requirements should be a function of the underlying convertibility of hedged financial

instruments. However, this exemption should be on fewer shares than the number required to fully hedge (e.g. 90%). This would discourage market makers from leveraging their exemptions by burdening them with long exposure in the market when such exemptions are taken advantage of.

Q. Under what circumstances might a market maker need to maintain a fail to deliver on a short sale longer than two days past settlement in the course of bona-fide market making? Is two days the appropriate time period to use?
A. Practically every type of bona-fide market making exposes participants to market risks not manageable with two day past settlement delivery requirements. Market makers must not be faced with liquidating hedges as the only option in reducing long exposure or the business of market making will become financially unsound. Therefore the only reasonable solution is to allow market makers to fail indefinitely on a certain number of shares determined by some type of formula related to the underlying hedges they hold.

Q. Are there circumstances in which a party not engaging in bona-fide market making might need to maintain a fail to deliver on a short sale longer than two days past settlement? If so, can such positions be identified? Should they be excepted from the proposed borrow and delivery requirements, and if so, why and for how long?
A. Unfortunately, even non market makers have legitimate reasons for failing to deliver. Stock lenders are constantly shuffling supply around to accommodate long sellers and to maximize return. Such activity makes adversaries out of brokers and their customers, and short time spans for delivery will make customers vulnerable. Perhaps those who have obtained "affirmative delivery" but lost the ability to deliver because of a long sale, could be granted a ten day exemption so that they have a little time to buy back their short. This type of exemption, although cumbersome, at least makes the consequences of failing to deliver a little less damaging, and helps create a more orderly market. The truth is that delivery requirements, in any form, hinder well functioning markets.

I hope the answers to the questions posed are helpful to members of your committee. And I hope The Commission has the wherewithal to look at the proposed rule changes from a broader perspective. There are certainly opportunities to better regulate short selling in the market. But unfortunately the current rhetoric in the media is not the answer. Once again I caution The Commission to look at its history and its role as a public institution in formulating new regulations. Good rules are not necessarily the most popular.

Our great president John F Kennedy, assassinated some forty years ago, talked about unpopular decision making in his book "Profiles in Courage", and his father Joseph Kennedy, at the direction of Franklin D Roosevelt, made difficult decisions as the first Commissioner of the SEC. He endeavored to restore the credibility of the markets in which bankers and stockbrokers had run amok. The public had fallen victim to stocks that they thought were credit worthy, but that were in actuality a vastly inflated product

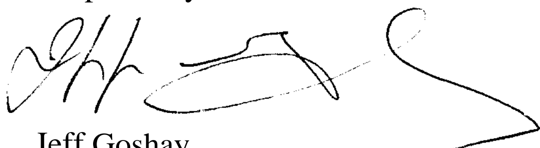
of investment bankers who had no rules governing dilution of publicly listed shares. The Depression that followed gave regulators a brief mandate to insure the integrity of American markets and they acted boldly. The rules subsequently developed were not designed to allow bankers and stockbrokers to manipulate stock prices back to lofty levels. The rules developed by Joseph Kennedy and adopted by The Commission in the Exchange Act of 1934 took great steps to protect public deposits in banks, and to prevent stockbrokers and bankers from creating and selling over priced shares. The resulting markets have provided the public with fairness in pricing, and liquidity widely acknowledged to be the best in the world since that time.

The Commission wisely decided then to let the market determine fair pricing, but it made sure the public received fair disclosure on publicly listed stocks, and it made sure the financial institutions holding public money were credit worthy.

Now The Commission is being asked to address "naked short selling" by curtailing the sellers who are deemed to be flagrant abusers of the rules. But the pundits do not say pricing will be improved. They do not say liquidity will be improved. They do not say the credit worthiness of our financial institutions will be improved. Only that these participants are causing the prices of certain stocks to be lower. One has to ask an obvious question however, should the government make rules to address this problem? Does The Commission want to write rules that allow **a** company and the investment banks that finance them, the ability to prevent, control, or slow down the downward movement of stock prices? If The Commission didn't write such rules in 1934, when the country was in the middle of its worst depression, why would it do so now? Wouldn't such rules pave the way for investment banks to simply float a small percentage of a company's shares, control access to short selling pressure, and allow shares to be sold to the public at inflated prices, or to be over leveraged at FDIC protected institutions? Wouldn't this put public savings and the integrity of the markets at risk? Isn't this what The Exchange Act of 1934 was designed to prevent?

The answers to these questions make it clear that The Commission should reverse course on the proposed rule changes. Instead The Commission should create new rules that allow for selling in all issues, regardless of float, that prevent manipulation of any sort, and that protect the rights of the owners of those shares. There is some difficult work ahead to accomplish these goals and it might not be particularly popular, but that work is within The Commission's role as a public institution. If The Commission keeps the credibility of our markets as its top priority its leadership will be compelling. Those who complain when sellers descend upon their stocks will nevertheless seek to buy, sell, and list securities here, where credibility in the market place has been paramount.

Respectfully,



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