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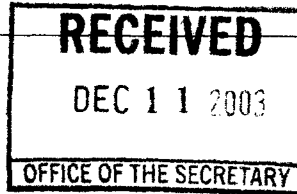

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December 10,2003

VIA COURIER

Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

FILE NO. S7-23-03

Attention.: Jonathan G. Katz, Secretary

Dear Mr. Katz:

Re: Comments on Proposed Regulation SHO

Introduction

1. On October 9, 2003, the Securities and Exchange Commission ("Commission") requested public comment on proposed Regulation SHO and certain amendments to Rule 105 of Regulation M. Regulation SHO would, among other things, require short sellers of all equity securities to locate securities to borrow before selling. It also proposes strict delivery requirements where significant failures to deliver the securities of a particular issuer had occurred. According to Release

No. 34-48709 ("Release"), these locate and strict delivery provisions were designed "to address the problem of "naked" short selling."

2. This comment letter addresses one aspect of Regulation SHO, namely the proposed locate rule set out in Rule 203 in respect of OTCBB and Pink Sheet securities. Specifically, this comment letter responds to two Commission questions, both posed in the Release, the first of which is "what benefits accrue from naked short selling?" The second related question is "whether reduced short selling opportunities may make the securities in [the OTCBB and Pink Sheet] markets more susceptible to having overvalued stock prices."

3. The thesis of this comment letter is that 'covered' short sales cannot be effected in many OTCBB and Pink Sheet stocks because the shares of those types of issuers often cannot be borrowed for short sale purposes. It is my view that this inability to borrow is often the result of the supply of some of these types of stocks being purposely constrained as part of an attempt to create artificial market prices for those stocks. If this is correct, then it would follow that the locate and related provisions of Regulation SHO *will* necessarily impair market efficiency and integrity in the OTCBB and Pink Sheet marketplaces, because there will be no 'upside' market constraints to check these artificial market prices. The result will be "...the substitution of an artificially stimulated and controlled market for an appraisal of the stock in a free and open market, which is the basis of fair dealing in a securities market..." [1]

4. While I am the president of a Vancouver-based securities dealer, the views and opinions set out herein do not necessarily represent those of such dealer.

The Conventional Short Sale Construct

5. The Release describes the mechanism of a short sale in the conventional manner, being one involving the sale of securities which the seller does not own. The

(short) sale will be settled with securities borrowed by the seller from a third party. Thus immediately after the short sale is executed, the purchaser will, on settlement, acquire a long position which will have been settled with the borrowed stock. The short seller will, on settlement, be short (i.e. owe the number of shorted shares) to the lender. That open position will be closed when the short seller covers the short position and repays the stock loan to the lender with the securities acquired in the covering transaction.

6. **An** essential element of the conventional short sale construct is the borrowing of stock by the short seller. This initial borrowing of the equivalent number of the shares to be shorted is required *only* to enable the purchaser under the short sale transaction to obtain settlement of the position purchased. That is, the borrowed stock will perfect the completion of the seller's short sale trade on the settlement date of that trade. [2]

7. In a so-called "naked" short sale transaction, the short seller will not borrow stock to perfect the completion of the trade on the settlement date. Accordingly the trade will not be completed on the settlement date of the trade; thus necessarily resulting in a "fail to deliver". According to the Release, this aspect of naked short selling has been the subject of many complaints by many issuers and investors, *especially in thinly-capitalized securities trading over-the-counter,* prompting some issuers to take defensive actions designed to make their publicly-traded securities unavailable for loan purposes. To close a short position, a naked short seller will either voluntarily undertake a subsequent covering trade (in the same way as a 'covered' short seller), or will be involuntarily required to cover by way of a clearing system buy-in initiated by a dealer with a unsettled long position.

8. During the period of time in which naked short sellers' positions are unsettled (i.e. uncovered), the naked short seller will be subject to the same market risks,

including margin consequences, as are short sellers who have borrowed stock to effect the settlement of their short sales.

9. Besides the failed settlement issue associated with naked short selling, there is another feature which does not arise with 'covered' shorting. This is reflected in the Release when it observes that "at times, the amount of fails to deliver may be greater than the total public float." This possibility arises because naked shorters will not be constrained in the total number of shares which they may sell short, unlike covered shorters who will, at least in theory, be limited to borrowing that number of shares comprising the public float. *In other words, the number of shares in the public float of an issuer will necessarily determine the total number of that issuer's shares which may be shorted.*

10. Under the conventional short sale construct, shares *must* be borrowed in order to undertake short sales. From this it follows that if there is no stock of a particular issuer available to borrow in the manner described above because of artificial supply constraints, then there could not be any short selling of that issuer's stock. Similarly, if an issuer has a public float but a portion of that float is artificially restricted, then the number of shares available to be borrowed, and therefore shorted, will be reduced by the number of shares so restricted. To the extent the public floats of OTCBB and Pink Sheet stocks are artificially constrained, short selling will be curtailed if stock is required to be borrowed to effect short sales of these types of securities.

OTCBB and Pink Sheet Stocks

11. As noted in paragraph 2 above, the focus of this comment letter is on the short selling of the publicly-traded stocks of OTCBB and Pink Sheet issuers. As the Release indicates, short sellers "reduce the risk that the price paid by investors is *artificially* high" (emphasis added) and thereby "add to stock pricing efficiency". Can the market prices of OTCBB and Pink Sheet equities be artificially high?

12. In a recent study,[3] Aggarwal and Wu compiled and assessed a dataset of 142 manipulation cases based on their review of Commission Litigation Releases between 1990 and 2001. Their analysis showed that "most manipulation cases happen in relatively inefficient markets such as the OTC Bulletin Board and the Pink Sheets that are small and illiquid." They concluded that "the vast majority of manipulation cases involve attempts to increase the stock price rather than to decrease the stock price..." These two conclusions are factual in nature, as opposed to constituting opinions, and are based on a decade of Commission enforcement actions. Other findings made in this study are:

   a. illiquid stocks have a higher likelihood of being manipulated than liquid, high capitalization stocks,
   b. of the 142 manipulation cases comprising the study's dataset, 84.51% involved inflated stock prices, *while less than 1% involved* ***price*** *deflation,*
   c. about 13% of the manipulators tried to *corner* the market in order to inflate market prices,
   d. stock prices rose throughout the manipulation period and fell thereafter, and
   e. when stocks are manipulated, their true values are not reflected in their market price, thus decreasing market efficiency.

13. The findings in the Aggarwal and Wu study are not remarkable. Most market observers would have intuitively concluded that the equities which are quoted on OTCBB and Pink Sheet markets could be more easily manipulated in "pump and dump" fashion than NYSE or NASDAQ **NMS** equities. The same most likely could be said of the other findings. For the purposes of this comment letter, it is sufficient to point out these empirical findings in light of the effect of the proposed "locate" provisions of Regulation SHO.

14. Another recent study [4] by Lamont assessed the market performance of the stocks of 270 American public companies, *excluding OTCBB (and presumably Pink Sheet) issuers,* which had adopted anti-shorting measures (or "short selling defenses") between March 1977 and May 2002. 78% of these events took place after 1990, and therefore the study period roughly parallels the review period of the Aggarwal and Wu study. The various types of defenses were broken down into three different categories, the third of which were called "technical actions". These included issuers attempting in "a variety of ways to get shares into the hands of friendly owners" as well as "trading-related actions." There were no statistically significant differences in the market performance returns among the three categories. One of the primary conclusions drawn by the study's author was that "short sales constraints allow stocks to become overpriced." The study also stated that "...in extreme cases where short sellers want to short a stock but find it difficult to do so, overpricing can be very large." Other conclusions of this study were:

    a. the anti-shorting actions examined showed that issuers who adopt anti-shorting defenses were "not just passively responding to stock prices, but [were] in fact actively trying to prop up their stock prices",
    b. a "notable feature" of many of the sample firms was that they were subsequently revealed to be fraudulent. The study notes "a rogues gallery of shady characters" being involved with some of the issuers comprising the study, and
    c. the short-term market return results of short squeezes (which Lamont defines as existing when a short seller was involuntarily forced to cover his short position because he was no longer able to borrow the security) are temporary, but the "long-term returns on these stocks are abysmal."

15. We have noted that the Lamont study *excluded* OTCBB (and likely Pink Sheet) issuers. Having said that however, there is nothing expressly mentioned in that study which could form the basis enabling one to assert that its conclusions would be different were OTCBB and Pink Sheet issuers included. Thus the pricing

hypothesis of the study would logically apply to OTCBB and Pink Sheet stocks, that hypothesis being "stocks are only overpriced when informed investors are unable or unwilling to short them. *No one would want to short them if they weren't overpriced, and they wouldn't be overpriced f they weren't hard to short"* (emphasis added).

16. The findings of the above-noted two studies are directly relevant to the thesis of this comment letter, and that is because stock supply constraints of OTCBB and Pink Sheet issuers will not only assist with 'upside' price artificiality (i.e. a constrained supply of stock will result in greater market price increases as demand for the stock increases), but it will also impede short selling. Consequently the pricing efficiency of market forces for a security constrained in this manner will necessarily be impaired. To paraphrase Judge Woolsey in *United States v. Brown et al:*

> 'If the market for a stock is a manipulated or controlled market in which a group is artificially raising the price of the stock on the only market to which a person who wishes to purchase the stock would inevitably resort, he obviously pays more – how much more perhaps cannot be estimated – than he would have paid in a free and open market. Hence he is a victim of unfair dealing. But he is entitled to fair dealing and should get it.'[5]

Manipulative and Abusive Naked Short Selling

17. The proposed locate and strict delivery provisions have been designed to deal with what is characterized as "the problem" of naked short selling, particularly in the thinly-capitalized securities markets of OTCBB and Pink Sheet issuers. The Commission observed in the Release that some manipulative schemes have included naked short selling as a constituent element. One such scheme is exemplified by the findings in *SEC v. Rhino Advisors, Inc. and Thomas Badian.* [6]

    I do not say that naked short selling cannot be manipulative. It is but one type of trade which may be manipulative, in the sense that it can result in an artificially

depressed price for a particular security such as existed in the market for Sedona Corporation stock referred to in the *Rhino Advisors, Inc.* proceeding.

18. The two other cases which the Commission refers to in the Release as involving manipulative short selling (*SEC v. Gardiner* and *U.S. v. Russo*) do not involve *naked* short selling, but rather covered short selling in conjunction with "parking" schemes designed to create artificial market prices.[7] By pointing this out I do not wish to be taken as positing that the two cited cases are irrelevant to the analysis because in both instances naked shorting could have been employed to accomplish the desired results.

19. The point I do wish to make in connection with the three above-noted cases is that the proposed locate and strict delivery requirements would not have prevented the manipulations in the *Gardiner* and *Russo* cases, as neither involved naked selling in the first instance. And in the *Rhino Advisors, Inc.* case, (as in the *Gardiner* and *Russo* cases), the manipulative scheme involved more than simply naked shorting.

20. The Release also refers to the "bear raid." A bear raid is said to create an "imbalance" of sell-side interest, thus "artificially" driving down the price of a security. It is said further that unrestricted short selling can "exacerbate" a declining market in a security by increasing pressure from the sell-side. As the Release notes, "Many people blamed "bear raids" for the 1929 stock crash and the market's prolonged inability to recover from the crash." Similar sentiments were expressed by the Commission in 1938 after the market decline in the fall of 1937.[8] The Commission, as then constituted, indicated that "concentrated" short selling of several NYSE stocks over two separate weeks had resulted (in one case) in what was described as an "concerted assault" on the market. This type of selling was seen as *"seriouslydestvuctive of stability"* (emphasis added).

21. The linking of increased levels of short selling to market price instability and price declines is not a recent phenomenon. Writing in 1892, Albert C. Stevens

recounts early attempts by the legislators of various governments to abolish short selling. [9] In the early 1600's, the Dutch banned short selling, and in 1802 Napoleon attacked the practice and made the short selling of public securities criminal. [10] Albert Stevens says the following in response to the then current legislative attempts to curb short selling on the basis that it caused price instability and depressed prices:

> "Following in the train of these gentlemen [elected officials and others advocating anti-shorting legislation] are thousands of other good people who appear to be pestered with such reasoning as the following:
>
> Because it is easy to offer and agree to sell that which one has not;
>
> Therefore, there is naturally a predominance of sellers in speculative markets;
>
> And, as free offers to sell tend to lower prices;
>
> Therefore, the existence of this freedom of short selling has the effect of "unduly depressing" prices.
>
> And then follows the easy conclusion that the farmer is "robbed" of a portion of his just dues by bear speculators.
>
> **As** a matter of fact the seller-short is consciously or otherwise a friend of the public, farmer as well as general consumer, for without him both would suffer from excessive fluctuation in prices far more than at present." [11]
>
> * * *
>
> "...the "short-seller," or "bear," will be found to be the safety-valve in the machinery of investment and speculation, a check upon investment and a regulator of price-movement to an extent which the general public have not yet learned fully to appreciate." [12]

22. It is not the purpose of this comment letter to engage in what is now a centuries-old debate about the market utility of short selling. Loss and Seligman put it well when they say that "short selling has been a favorite whipping boy, both when it has deserved to be and when it has not." [13] In that respect to is sufficient for my purposes to rely on the Commission's opinion, expressed in the Release, that short selling adds to stock pricing efficiency because it informs the market of short

sellers' evaluations of future stock price performance. The Release continues: *"This evaluation* is *reflected in the resulting market price of the security"* (emphasis added). Therefore without short selling, naked or otherwise, market efficiency would be adversely impacted. Markets would not be efficient were short selling to be prohibited or curtailed due to a stock's supply being artificially constricted. That would necessarily result in *overvalued,* manipulated prices.

23. Another way to look at the "depressed prices" argument is to consider whether a similar number (volume) of sales from long positions would have the same market effect as the identical volume of short sales. Presumably the market effect of both types of sales would be the same, yet long sales are not viewed as destructive, destabilizing or as depressing as short sales. More significantly, if 'speculative' selling can be destructive, then logically the same can be said for speculative buying. Yet curbs on bull traders (or "bull raiders" as I am tempted to call them) in an overheated or speculative market, such as the hi-tech bubble of the late 1990's, are not suggested. "If Congress and the SEC have determined that excessive speculative swings in the market are contrary to the public interest, it would seem a logical correlative to the uptick rules to adopt downtick rules to prevent the acceleration of a rising trend."[14] It is almost as if downward trending market prices are an inherently bad thing, and upward trending market prices are an inherently good thing. It is my belief that neither of these opposing price movements are good or bad, in and of themselves. What is important is that market prices are not artificial in the sense reflected in the above-noted passages taken from the *Brown* case. All equities markets *must* reflect an appraisal of the listed or quoted stocks on these markets in a free and open market, so that the quoted market price will represent a chancering of that market price due to supply operating against demand.

Conclusion

The concern expressed in this comment letter is quite simple. It is that if the supply of the stock of an OTCBB or Pink Sheet issuer is artificially constrained, then the market

price for its stock will be overvalued.[15] This type of stock supply constraint will not only result in an overvalued market price, but will also retard short selling, which would result in corrective downward price pressure on the overvalued security.

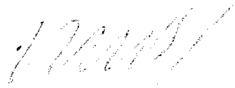
The issue of whether the Regulation SHO locate and strict delivery requirements should be applied universally to OTCBB and Pink Sheet stocks is a threshold issue. That is, if the Commission concludes that these provisions should be so applied, then that will be dispositive of the issue. If however, the Commission concludes that the proposed provisions are not a suitable remedy, then several aspects of naked shorting will have to be considered. These issues primarily involve the settlement procedures which would have to be adopted to accommodate naked short sales.

As noted in the Release, the Commission must conclude that the proposed locate and strict delivery provisions are necessary or appropriate in the public interest. It has concluded on a preliminary basis that these measures will address the "larger failures to deliver securities that have the potential to disrupt market operations and pricing systems". The question presented by this comment letter is whether these same provisions will, in the case of OTCBB and Pink Sheet markets, have the unintended consequence of essentially 'playing into the hands' of unscrupulous promoters. Mr. William Johnson's email comment (November 5, 2003) to the Commission on this subject typifies this concern, and is an apt way to conclude this letter:

> "Major Mistake:
>
> 1) Sleazy promoters will pull all stock out of DTC
> 2) Market makers will check to see if stock is in DTC to be borrowed. When it isn't, they will NOT fill any orders on the stick, because they know the game is on to manipulate the stock higher (Would you sit there and print losses all day)?

3) Stocks will go from pennies to dollars VERY QUICKLY and come down just as fast.
4) If your objective is to increase volatility, you will accomplish that.
5) The SEC, must include a provision whereby a certain % of stock is in dtc, othenvise this a penny stock manipulator's DREAM COME TRUE
6) There are may unintended consequences of this action. Please think it thru…."

ALL OF WHICH IS RESPECTFULLY SUBMITTED.



Douglas R. Garrod

Endnotes

1. *United States v. Brown et al* (1933) 5 F. Supp. 81, at 84. See also *Securities and Exchange Commission v. Torr et al* (1938) 22 F. Supp. 602 at 608: "…to create an artificial market which appears to be real is something that is most unfair to the public…".

2. This analysis is somewhat simplified because the Continuous Net Settlement system aggregates trades on a continuous daily basis at the dealer level. Thus the initial unsettled long position will in most cases be 'passed on' or 'circulated' in the settlement system to a dealer unconnected with the initial short sale transaction.

3. Aggarwal, Rajesh K. and Wu, Goujun, March 11, 2003, *Stock Market Manipulation – Theory and Evidence,* Tuck School of Business, Dartmouth College and University of Michigan Business School.

4. Lamont, Owen, January 2, 2003, Go *Down Fighting: Short sellers vs. firms,* Graduate School of Business, University of Chicago.

5. Unites States v. Brown et al, *op. cit.*, at 85.

6. Litigation Release No. 18003 (February 27, 2003). The case involved contractual breaches, fraud, wash sales and match sales as part of the manipulative scheme.

7. *SEC v. Peter R. Gardiner,* Litigation Release No. 12818 (March 27, 1991) and *U.S.* v. *Russo*, 74 F. 3d 1383 (January 11, 1996).

8. Securities Exchange Act Release No. 1548 (January 24, 1938).

9. Stevens, Albert C., (1892), *The Utility of Speculation in Modern Commerce* Political Science Quarterly, **4**19 at 420.

10. Louis Loss and Joel Seligman, *Securities Regulation,* (3[d] ed.), section **8-B-3,** at **7.**

11. Stevens, Albert C., *supra,* at 423.

12. *Ibid,* at 426.

13. Loss and Seligman, *op. cit.*, at 6.

14. Karmel, Roberta S., (1973) *Short Selling,* Securities Law Review, 531 at 538.

15. Jarrow, Robert A. (1992) *Market Manipulation, Bubbles, Corners and Short Squeezes,* Journal of Financial and Quantitative Analysis, 311. **At** 317, Jarrow says "…relative prices decrease with decreases in the speculator's demands *except* when there is a market corner or a short squeeze... The speculator can arbitrarily determine the price."