The proposed SEC "Naked" Short Selling Anti-Fraud Rule is completely unenforceable.

While I understand that, in the ideal financial system, the existence of a rule will induce most concerned parties to comply voluntarily, it should also be realized that just a small percentage of non-compliance can result in massive dollar amounts of fraud affecting large segments of the investing community.

The reason I believe the rule is unenforceable is simple. In Section III A the rule makes it "unlawful for any person to submit an order to sell a security if such person deceives a broker-dealer or purchaser regarding its [sic] intention or ability to deliver the security on the date delivery is due, and such person fails to deliver the security on the date delivery is due."

The need to prove intent or ability makes the rule unenforceable in almost all cases. The SEC cannot possibly investigate and prosecute most cases of delivery failure. The vast majority of broker-dealers and clearing agencies have neither motivation nor financial resources to pursue enforcement of the rule. In many cases they are willing participants and beneficiaries of the seller's short sale and have nothing but trouble to gain from voluntary enforcement. The true victims of "Naked" short selling are often the multitude of retail buyers who are unaware of the transaction.

This rule can be greatly simplified and made enforceable by a simple change:

Purchasers of securities that involve fail to deliver, or the broker-dealers representing them, shall have the right, upon failure of delivery on the required date, to demand via appropriate form filed with the SEC and served on the sellers or their broker-dealer,

(a) that the original purchase cost plus commissions and fees be credited to the buyer's account, or
(b) that the sellers provide the purchased number of securities plus an additional one percent of that number for each day that the actual delivery exceeds the original scheduled delivery date.

The buyer, or his broker-dealer, shall have the right to indicate on the SEC form which of these options is to be taken. Their decision obviously will be keyed to the market value of the securities after the fail date.

Further, the rule should require that the SEC collect a statutory fine of $10,000 from the seller, and $10,000 from his broker-dealer, for each "fail delivery" form received. Each such form, and any subsequent appeals to the fines attached, shall be referred to the US District Attorney.

The incorporation of this provision will greatly simplify Section III A and make it almost completely self-enforcing. The actual fail delivery will be the only trigger for action. Buyers and brokers suspecting fraud will demand verification of delivery. The SEC

should use the proceeds from fines to improve the system of detection and tracking of fails in delivery, which system should generate automatic notices to the parties involved.

Cases in which a single broker-dealer represents both buyer and seller require special attention. This arrangement is prima face indication of conflict of interest, I believe, and it should be dealt with by special SEC regulations. Similarly, "fail delivery" forms submitted fraudulently will need to be addressed in a separate section of the Rule. If the SEC uses fines to improve the detection and tracking system, such cases will be rare.

It may be argued that the use of fail delivery as the only trigger for the Rule still allows three days of naked short selling. This is true only if the short sellers can repurchase and deliver the requisite securities in less than three days. That requirement itself will deter many fraudulent short sales. Meeting it will become more difficult as technology allows the delivery time for short sales to be reduced to two and, eventually, to one day. The residual "legalized fraud" will be a small price to pay for automatic enforcement in the majority of cases.

While I believe that a self-enforcing rule is the best and the only approach to the naked short selling scandal that is about to emerge, I am also aware that the SEC has never, and may never, take this non-traditional approach. In my view, the Commission must weigh the security of its traditional rule-making methods against the long-term disruption to the markets, and to the Commission itself, that will result if the present situation is not effectively corrected.