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Ms. Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F St. NW
Washington, DC 20549-9303

File No. S7-19-07

Dear Ms. Morris:

Here are my comments on the proposed changes to Regulation SHO with regard to eliminating the market maker exception and the marking of sell trades. In brief, the proposed elimination of the option market maker exemption is a reasonable improvement to the existing state of affairs and should be implemented soon.

However, the overall rules -- even with the amendments -- do nothing to prevent settlement failures in the first place. The rules are a classic example of complex, expensive, and ineffective "command and control" regulation which should be replaced with more cost effective market-based regulation. The proposed rules add another level of complexity (and compliance cost) to a system that was badly designed in the first place.

So far, Regulation SHO and the associated enforcement efforts have made some progress on the problem. However, hundreds of stocks still wind up on the Threshold List on any given day. During the first 18 months of Regulation SHO, over 20% of NYSE-listed stocks wound up on the list, as well as over 20% of NASDAQ-listed and AMEX-listed stocks. Some companies have stayed on the list for over a year. Even the NYSE itself was on the Threshold List for over 100 days.

This is an embarrassment to the U.S. capital markets. Investor concern about the potential for price manipulation inherent in the practice of selling stocks without delivering them at the customer time casts a cloud over the reputation of the U.S. capital markets. Furthermore, the opacity of our settlement institutions with respect to the nature and extent of the problem makes it difficult for individual investors to determine for themselves whether or not there is a problem.

The convoluted nature of the rules and the exceptions has led to lots of alleged game playing. Some options market makers have apparently been renting out their exemption.

Other investors appear to be resetting the 13 day clock through various artifices in order to roll over their fails. The lack of clarity engendered by the complexity of the rules required the Commission to attempt to further explain the options market maker exemption in the latest release.

The command and control approach requires ever more complex rules and enforcement headaches, with attendant compliance costs for brokers and investors. This system should be replaced with market-based regulation that makes those who fail to deliver shares on time bear the economic cost of doing so.

Good riddance to the option market maker exemption.

Getting rid of the options market maker exception is a good idea. Options market makers should have to pay to borrow stock like everyone else does. Most options market makers are excellent risk managers, and they can manage the risk that stock borrowing costs can fluctuate. Any additional costs involved will rightfully be passed to those who trade options.

Debating whether buy-ins should be required in 3 days, 13 days, 31 days, or 3,100 days is the wrong way to go. Any extended deadline just gives the failing parties more time to fail (at the expense of the failing to receive parties), and it creates opportunities for stock manipulation around the deadline dates. If you give people more time to deliver, then they will take all the time you give them when it is in their best economic interest to do so. Instead, the Commission should remove the economic incentives that lead to the failure to deliver problem.

The long sale marking requirement is useless. Protracted fails are ECONOMIC decisions, not back office incompetence.

The proposed marking requirements for long sales would seem to help in compliance with the rules. If brokers must document the location of shares, then they will know that they have to find shares by T+3. I suspect that short sales that have been accidentally misclassified as long are only a very small part of the problem when there are protracted failures to deliver.

This marking requirement will impose implementation costs on every broker dealer and do absolutely nothing to prevent the protracted failures to deliver that are the source of this public controversy.

Settlement failures are fundamentally an economic incentive problem.

Settlement failures can occur for a number of reasons such as operational glitches that delay settlement. However, protracted settlement failures are fundamentally an economic issue. Normally, sellers have a strong incentive to deliver shares on time because they

don't get paid until they deliver. Even short sellers have an incentive to deliver on time as they usually receive a "short rebate" of some of the interest on the collateral they post for their stock borrowing. Protracted settlement failures are only found in situations in which the stock is so hard to borrow that the rebate is negative -- in other words, when the shorts actually have to pay hard cash to borrow the stock.¹

If the economic incentive to fail were eliminated, there would be almost no fails, with the exception of the occasional back office glitches which are usually resolved quickly. The marking requirement would be unnecessary. Similarly, if the economic incentive to fail were eliminated, the location rule would also be totally unnecessary as there would be virtually no fails.

AS LONG AS THERE IS AN ECONOMIC INCENTIVE TO FAIL TO DELIVER, THERE WILL BE FAILURES! As long as the economic incentive is there, clever parties will find ways to maneuver around the rules in order to fail for as long as they possibly can. No matter how long the buy-in period is, they will find ways to roll over their fails and reset the clock, leading to an endless cat and mouse game between evasion and enforcement.

Parties failing to deliver should pay the costs they are imposing on others.

Protracted settlement failures will only disappear when the economic incentives to fail have disappeared as well. As those who fail to deliver hard-to-borrow securities are forcing the buyers to lend them the securities at below market rates, the economic incentive will only disappear when the failing parties are forced to pay the economic costs that they are imposing on others.

Clearing agencies should be required to charge penalties for parties failing to deliver.

Congress directed the SEC under §17A(a) 2. A. i of the '34 Act to use its authority "to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of transactions in securities." Note that Congress put the word "prompt" here. Situations in which fails to deliver last for months and years are anything but prompt.

To borrow from the techniques used in Regulation NMS to prevent trade-throughs, the SEC should require clearing agencies to adopt rules that are "reasonably designed" to reduce failures to deliver, and then let the clearing agencies exercise their SRO expertise to come up with the detailed rules.

¹ Of course, short sellers in a fail-to-deliver situation can also benefit from the impact of selling the failed shares on the price of the stock. The creation of selling interest *ex nihilo* puts downward pressure on the price of the stock.

All of the Threshold List rules could be replaced with the following:

Each clearing agency shall establish, maintain, and enforce written rules that are reasonably designed to:

- (1) Require its members to deliver securities on the customary settlement date;*
- (2) Provide appropriate economic penalties to members failing to deliver a security on the customary settlement date; and*
- (3) Publicly disseminate on its web site daily information regarding the number of shares that are failed to deliver for each security.*

“Appropriate economic penalties” could be defined as “an amount not less than 125% of the amount that the securities could have been borrowed for in the stock lending market as determined by the clearing agency. Thus, stock borrowers would have an incentive to actually borrow shares through the stock loan market rather than pay the penalty rate through DTCC. The revenue from the penalties could be used to compensate those who are failing to receive, or it could be used to offset other expenses of the clearing agencies.

This would be a simpler and much more cost effective solution than the Threshold List approach. SRO and SEC enforcement teams would not be spending scarce enforcement resources enforcing paperwork rules like the marking and location rules. Furthermore, delegating the details to the SRO means that the final solution will probably be more efficient than a solution micromanaged at the SEC level.

Removing barriers in the stock loan market will also reduce incentives to fail.

Another way to reduce settlement failures would be to remove regulatory impediments that sometimes make it excessively expensive to borrow or lend stock. In particular, the well meaning customer protection Rule 15c3-3 makes it very burdensome to lend stock out of cash accounts or to lend “excess margin securities” out of margin accounts. These rules can be relaxed without jeopardizing the all-important protection of customer securities. Brokerage firms routinely lend shares out of margin accounts with adequate consumer protection, and the same protections that protect margin account shares can be used to protect cash account shares.

The Regulatory Flexibility Act Analysis is inadequate because it ignores more cost effective solutions used in other countries.

As is unfortunately typical in SEC rule proposals, there is no mention of how other jurisdictions deal with similar problems. We can thump our chests and brag about how our capital markets are (or used to be) the best in the world, but that does not mean that

we cannot learn from other countries. Indeed, the U.S. has been leapfrogged by other countries in areas such as stock exchange automation and dematerialization. In particular, in the U.K those who fail to deliver on time are charged fees known as “settlement disciplines.” The SEC should explicitly consider the approaches used in other countries to motivate participants to deliver shares on a timely basis. I am aware of no foreign jurisdiction that has come up with a system as complex and ineffective as our Threshold List system.

This is a major rule under SBREFA.

As much as I do not want to see these needed improvements delayed, I must point out that there is a major economic impact here which makes this a major rule under Small Business Regulatory Enforcement Fairness Act of 1996 (SBEFRA). My calculations indicate that the market value of failures to deliver averaged \$2.8 billion per day in 2005 for NYSE-, AMEX-, and NASDAQ-listed stocks alone. Investors appear to be losing over \$100 million per year in lost stock lending revenue due to failures to receive shares of hard-to-borrow stocks on time.² By reducing these delivery delays, investors would be able to earn stock loan revenue for these shares if they wanted to.

Of course, buyers sometimes benefit when there is a settlement delay in a stock that is not hard to borrow. Because the buyer does not have to pay until delivery is made, the buyer gets full use of the funds while awaiting delivery. As the potential lending revenue is less than the interest that could be earned on the funds, the buyer may actually benefit by the delay unless there are some complications around dividend payments or shareholder votes.

Respectfully submitted,

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² I arrived at this figure in two ways. The first was to look at the list of securities on the SEC Regulation SHO Threshold List. These are stocks for which the settlement failures exceed one half of one percent of the shares outstanding among other criteria. Then calculate the market capitalization of each stock on the list and multiply by an estimate of the appropriate stock lending rate for Threshold List stocks. As the inhabitants of the Threshold List may have substantially higher rates of failure (sometimes in excess of 10% of the shares outstanding!), this provides a lower bound on the estimates. The other method is to use historical data on failures to deliver obtained through Freedom of Information Act requests to calculate the market value of the shares failing to deliver, and then multiply by an appropriate stock lending rate. For 2005, the market value of fails for NYSE/AMEX/NASDAQ stocks (but not OTCBB or Pink Sheets) averaged \$2.8 billion per day. If these stocks were hard to borrow and could command an average negative short rebate of 4%, then the lost stock loan revenue alone was \$112 million. Adding lost stock loan revenue on OTCBB and Pink Sheets stocks, back office clerical costs, compliance costs, SRO/SEC enforcement costs, and damage from stock manipulation adds substantially more to these costs.