MEMORANDUM

TO: File Nos. S7-19-07 and S7-20-08

FROM: Cyndi Rodriguez
Office of Commissioner Aguilar

DATE: October 27, 2008

RE: Meeting with Representatives of Overstock.com, DowLohnes Government Strategies and Haverford Group

On September 8, 2008, Jonathan Johnson of Overstock.com, Kenneth Salomon of DowLohnes Government Strategies LLC, and John Wellborn of the Haverford Group met with Commissioner Aguilar and his counsel, Cyndi Rodriguez. They discussed issues related to the amendments to Regulation SHO, Rel. No. 56213 (S7-19-07) and the Emergency Order, Rel. Nos. 58166 and 58190 (S7-20-08) and issues related to data on the volume of failures to deliver.

Mr. Johnson followed up this meeting by sending further comments in an email attaching several documents that were presented at the meeting: "Naked Short Selling and The SEC Emergency Order" (Tab A); John Wellborn's "The 'Phantom Shares' Menace" (Tab B); and charts showing the share and mark-to-market volume of failures-to-deliver from Q2 '04 through Q2 '08 (Tab C).

Attachments

NAKED SHORT SELLING AND THE SEC EMERGENCY ORDER

• On **July 15, 2008**, the SEC announced an **emergency order** to prevent "naked" short selling in the securities of Fannie Mae, Freddie Mac, and 17 primary dealers and banks. The order required that short sellers (except for registered market makers[1]) pre-borrow prior to effecting short sales.[2] The order became effective on **July 21** and was extended until **August 12**, the maximum time permitted by law.[3]

• **Short selling** is a bet that a stock price will decline. A short seller borrows stock and then sells it, hoping to buy back the same amount of stock later, at a lower price, for return to the lender. Short selling is legal and an important tool for liquidity and efficient price discovery.

• **Naked short selling** involves selling stock without borrowing (or sometimes even locating) the stock. If a naked short seller does not borrow the stock he sold, he will be unable to deliver that stock and settle the trade. This is called a **"failure to deliver" (FTD)**. Naked short selling is generally illegal, though options market makers may naked short and fail to deliver when engaged in *bona fide* market making.

• Exchanges do not disclose whether short positions are naked. To complicate matters, physical shares of stock have been separated from electronic claims of ownership through "**dematerialization**." Modern stock markets trade in **"share entitlements"** and not real shares. Retail brokerage customers' account statements do not distinguish between real shares and share entitlements. Thus, purchasers of securities have no way of knowing whether shares they bought were actually delivered to their broker.[4]

• FTDs create **phantom shares** that circulate in the system as real shares. Just as counterfeit currency dilutes and destroys value, phantom shares deflate share prices by flooding the market with false supply. FTDs threaten market integrity in at least three ways:

1. **The corporate voting system is undermined**. FTDs can lead to more claims of ownership than there are shares issued, and attempted over-voting at the broker-dealer level is routine;[5]
2. **Companies and shareholder value are destroyed**;[6]
3. **Market integrity is threatened**. Large brokerage firms and hedge funds often use leverage to build naked short positions, a strategy that poses systemic risk to financial markets.

• **Regulation SHO** was implemented by the SEC in January of 2005, in order to curb abusive naked short selling and reduce FTDs. Regulation SHO requires the exchanges (e.g., NYSE and NASDAQ) to publish daily the **Regulation SHO Threshold List**, which lists firms with FTDs above a calculated threshold.[7]

• Since Regulation SHO was enacted, over **7,000** unique tickers have appeared on the Threshold List.[8]

• Regulation SHO only reports victim companies; the institutions who fail to deliver are not revealed. The size of past (but not current) FTDs can be obtained through the SEC's **Freedom of Information Act (FOIA)** office.[9] Neither the SEC nor the exchanges will disclose the institutions who fail to deliver as "fails statistics of individual firms…is proprietary information and may reflect firms' trading strategies."[10]

• The SEC's prediction that firms could not remain on the Threshold List longer than 13 days was false: [11]

TOTAL # OF DAYS ON THE THRESHOLD LIST	# OF COMPANIES
13+	4775
50+	1845
100+	833
200+	233
400+	35
600+	8
800+	2

• New data reveal significant FTDs across all U.S. exchanges and as a fraction of select issues[12]:

	DATE	FTDS	MARK-TO-MARKET VALUE OF FTDS (ALL STOCKS)[13]	MARK-TO-MARKET VALUE (SHO STOCKS ONLY)
All U.S. Exchanges	3/31//2008	1,251,001,120	$8.475 Billion	$6.145 Billion

ISSUER	PEAK DATE	PEAK FTDS	SHARES OUTSTANDING[14]	FTDS AS A % OF SHARES OUT.	TOTAL DAYS ON SHO LIST[15]
Ambac Financial (NYSE: ABK)	2/6/2008	5,608,722	101,550,000	5.52%	75
Bear Stearns Companies (NYSE: BSC)	3/20/2008	13,789,126	118,091,000	11.68%	34
Bidz.com, Inc. (NASDAQ: BIDZ)	11/29/2007	1,263,401	23,844,000	5.30%	161
Dendreon Corp. (NASDAQ: DNDN)	5/17/2007	17,715,131	83,506,000	21.21%	324
Force Protection (NASDAQ: FRPT)	7/2/2007	2,583,493	68,010,000	3.43%	297
M B I A Inc. (NYSE: MBI)	1/28/2008	4,9793,41	125,394,000	3.97%	81
Medis Technologies (NASDAQ: MDTL)	8/15/2007	2,946,125	35,053,000	8.40%	806
Netflix (NASDAQ: NFLX)	10/20/2004	6,907,963	52,152,000	13.25%	605
Overstock.com (NASDAQ: OSTK)	3/20/2006	3,800,172	19,435,000	19.55%	839
Taser International (NASDAQ: TASR)	12/6/2004	8,102,052	59,296,000	13.66%	563
Take-Two Interactive (NASDAQ: TTWO)	2/28/2008	6,626,701	74,331,000	8.92%	289

• Studies have shown that FTDs can be strategic and manipulative.[16] **SEC Chairman Christopher Cox** recently wrote, "Naked short selling can turbocharge "distort and short" schemes…[and] allow manipulators to force prices down far lower than would be possible in legitimate short-selling conditions."[17] According to TV personality and former hedge fund manager **Jim Cramer**, ""When you sell a stock short you've got to borrow it first. That's the rule. But shorts have been violating that rule left and right. Selling stock first; finding it later—if they even bothered."

• Large U.S. brokerages collectively own the **Depository Trust and Clearing Corporation (DTCC)**, which operates with little SEC oversight and denies the existence of a systemic problem.[18] The DTCC claims that failed trades at the end of 2007 summed to $7.5 billion[19]—1.5% of the daily dollar volume. But that $7.5 billion is only the "**mark-to-market**" value of failed trades; the true cost is far higher:

	2006	2007	Difference	% Change
FTDs	$3,749,160,000	$7,454,648,000	$3,705,488,000	98.8%
FTRs	$2,643,433,000	$5,761,192,000	$3,117,759,000	117.9%
SBP	$1,105,727,000	$1,693,456,000	$587,729,000	53.2%
Open Positions	$7,498,320,000	$14,909,296,000	$7,410,976,000	98.8%

• The true magnitude of FTDs is obscured by **Continuous Net Settlement (CNS)**, which nets failures against shares held at DTCC.[20] The DTCC's **Stock Borrow Program (SBP)** further obscures the truth.[21] Furthermore, the statistics above omit **"ex-clearing"**—that is, trades cleared directly by brokers bypassing the DTCC. Ex-clearing trades are exempt from the reporting requirements of Regulation SHO."[22] FTDs in ex-clearing may be many times larger than the quantities discussed above.

NAKED SHORT SELLING: THE SOLUTION

• The FTD problem can be solved by four rules. All are simple, easy to implement, and fair:

G: eliminate the **G**randfather provision of Regulation SHO;
O: eliminate the **O**ptions market maker exception;[23]
L: require those who sell short to first **L**ocate and actually borrow *bona fide* shares; and
D: require full and prompt **D**isclosure of FTDs by broker-dealer and by company.

Members of the House Financial Services Committee[24], the American Bankers Association[25], academics, public companies[26], and the U.S. Chamber of Commerce are urging the SEC to accept the four GOLD rules above.[27] SEC has adopted 'G' but is considering only weak versions of the 'O' and 'D' rules.[28] A new rule was recently proposed to address "L," but it is unclear if or how that rule will be enforced.[29]

Treasury Secretary Hank Paulson has said, "In terms of naked shorts, my view on that is naked short selling is wrong anywhere. Any investor before they sell short should line up the stock and that goes without saying."[30] **NASDAQ OMX CEO Robert Greifeld** shares this belief: "If you want to sell short, you can do that but you have to locate the long position before you can sell short. That's where we need to get to as an end state."[31] The SEC should extend the emergency order to all issuers and permanently impose a pre-borrow requirement for short sales.[32]

[1] SIFMA, "Short-sale Guidance From the SEC "Essential"" (July 28, 2001), http://www.sifma.org/news/news.aspx?id=6346.
[2] "SEC Enhances Investor Protections Against Naked Short Selling" (July 15, 2008), http://sec.gov/news/press/2008/2008-143.htm.
[3] "SEC Extends Order Limiting Naked Short Selling Through August 12" (July 29, 2008), http://sec.gov/news/press/2008/2008-155.htm.
[4] Arne Alsin, "The story brokers don't want you to read," *Financial Times* (October 20, 2006).
[5] Bob Drummond, "Corporate Voting Charade," *Bloomberg Markets Magazine* (April 2006).
[6] Bob Drummond, "Games Short Sellers Play, *Bloomberg Markets Magazine* (November 2006).
[7] Securities and Exchange Commission, Final Rule: Short Sales, Release No. 34-50103 (July 28, 2004), http://www.sec.gov/rules/final/34-50103.htm.
[8] Data from Buyins.net as of July 16, 2008.
[9] Securities and Exchange Commission, "Frequently Requested FOIA Document: Fails-to-Deliver Data — Archive Data" (as of June 4, 2008), http://www.sec.gov/foia/docs/failsdata-archive.htm.
[10] Securities and Exchange Commission, "Division of Market Regulation: Key Points about Regulation SHO" (April 11, 2005), http://www.sec.gov/spotlight/keyregshoissues.htm.
[11] Data from Buyins.net as of July 16, 2008.
[12] SEC, Fails-to-Deliver Archive Data.
[13] Price data from Bloomberg, CSIData, Dow Jones, FinancialContent, MarketWatch and Tick Data.
[14] Data from Bloomberg.
[15] Data from Buyins.net as of July 16, 2008.
[16] Leslie Boni, "Strategic Delivery Failures in US Equity Markets," University of New Mexico and the SEC (November 2004), http://www.unm.edu/~boni/Fails_paper_Nov2004.doc. See also John D. Finnerty, "Short Selling, Death Spiral Convertibles and the Profitability of Stock Manipulation," Fordham University (March 2005), http://www.businessjive.com/nss/jdfinnerty050505.pdf and Richard B. Evans et al, "Failure is an Option: Impediments to Short Selling and Options Prices," The Wharton School at the University of Pennsylvania (May 5, 2003), http://www.businessjive.com/nss/failureoption.pdf.
[17] Christopher Cox, "What the SEC Really Did on Short Selling," *Wall Street Journal* (July 24, 2008), http://sec.gov/news/speech/2008/spch072408cc.htm.
[18] Larry Thompson, DTCC First Deputy General Counsel, "Naked Short Selling and the Stock Borrow Program" (March 2005), http://www.dtcc.com/Publications/dtcc/mar05/naked_short_selling.html.
[19] National Securities Clearing Corporation, "Consolidated Financial Statements for the years ended December 31, 2007 and 2006," http://www.dtcc.com/downloads/annuals/2007/dtcc_consolidated_2007.pdf.
[20] DTCC, "Continuous Net Settlement (CNS)," http://www.dtcc.com/ProductsAndServices/clearing/cns.html.
[21] Larry Thompson, DTCC First Deputy General Counsel, "Naked Short Selling and the Stock Borrow Program."
[22] Robert Shapiro, "Comments on Proposed Amendments to Regulation SHO" (September 14, 2006).
[23] Securities and Exchange Commission, Final Rule: Short Sales, Release No. 34-50103, Rule 203, Section 1b, "Exemptions from the Locate Requirement: Bona-fide Market Making." (July 28, 2004), http://www.sec.gov/rules/final/34-50103.htm.
[24] Rep. Paul E. Kanjorski (D-PA), House Financial Services Committee (July 24, 2008), http://www.house.gov/apps/list/hearing/financialsvcs_dem/hr072408.shtml; Rep. Spencer Bachus (R-AL), HFS (July 24, 2008), http://republicans.financialservices.house.gov/news/PRArticle.aspx?NewsID=227; Rep. Chris Murphy (D-CT), HFS (July 24, 2008), http://www.house.gov/apps/list/hearing/financialsvcs_dem/hr072408.shtml.
[25] Ed Yingling, American Bankers Association, Letter to Christopher Cox (July 15, 2008).
[26] Jonathan E. Johnson III, Overstock.com, Letter to Erik Sirri (July 23, 2008) http://www.sec.gov/comments/s7-20-08/s72008-179.pdf.
[27] See Securities and Exchange Commission, "Comments on Proposed Rule: Amendments to Regulation SHO," http://www.sec.gov/comments/s7-12-06/s71206.shtml and David Chavern, COO and Senior Vice President, US Chamber of Commerce, Letter to Sen. Christopher Dodd and Rep. Barney Frank (February 16, 2007).
[28] Securities and Exchange Commission, "SEC Votes on Regulation SHO Amendments and Proposals; Also Votes to Eliminate "Tick" Test," http://www.sec.gov/news/press/2007/2007-114.htm . See also, Securities and Exchange Commission, "Amendments to Regulation SHO [Release No. 34–56213; File No. S7–19–07]" (September 13, 2007), http://sec.gov/rules/proposed/2007/34-56213.pdf.
[29] Securities and Exchange Commission, "'Naked' Short Selling Anti-Fraud Rule 10b-21 [Release No. 34–57511; File No. S7–08–08]" (March 17, 2008), http://sec.gov/rules/proposed/2008/34-57511.pdf.
[30] Hank Paulson, "Paulson's Rescue Plan," CNBC (July 21, 2008), http://www.cnbc.com/id/15840232?video=799510106.
[31] Robert Greifeld, CEO, NASDAQ OMX, "Naked Short sale Rules for All Stocks?" (July 24, 2008), http://glickreport.blogs.foxbusiness.com/2008/07/24/naked-short-sale-rules-for-all-stocks/.
[32] John Welborn, "Act on naked short-selling fraud", *Financial Times* (July 23, 2008), http://www.ft.com/cms/s/0/bc925b24-584f-11dd-b02f-000077b07658.html.

Naked short selling distorts shareholder control.

The 'Phantom Shares' Menace

By John W. Welborn
The Haverford Group

In 1985, the National Association of Securities Dealers (NASD) commissioned Irving M. Pollack, a securities law expert and former Securities and Exchange commissioner, to conduct a comprehensive review of short selling in NASDAQ securities. The NASD sought to determine what, if any, additional short selling regulation was needed for the NASDAQ market. The result was the now-famous "Pollack Study," which described the short selling landscape of the day and made important recommendations regarding the disclosure, reporting, and settlement of short sales.

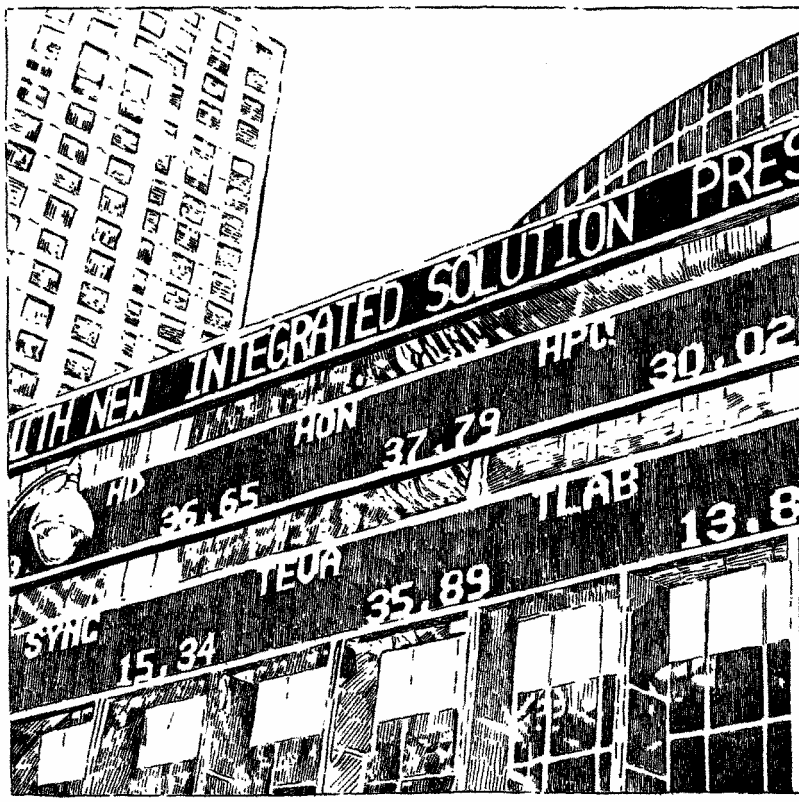
Pollack concluded that short selling was a vital source of liquidity and a valuable mechanism for efficient price discovery. He added, however, that without proper institutions to guarantee prompt clearance and settlement of short sales, short selling was open to abuse. Of the settlement regime, he cautioned that it "effectively insulates the clearing corporation and brokers from fails to deliver and receive by contra-parties; but it permits fails to deliver and receive to develop without an automatic check." He issued a sober warning:

> The fail-to-deliver/fail-to-receive problem has the potential for causing serious difficulties in a lengthy bear market. While the evidence does not suggest that delivery problems exist in many securities, the fact that there is no automatic mechanism preventing the substantial buildup of short positions at the clearing corporation and of fails to receive in brokerage firms carries the potential for serious problems, particularly in the event of crisis market conditions.

The phrase "short positions at the clearing corporation" refers to "failures to deliver" (FTDs), which effectively increase the net supply of an issue in circulation and, by definition, depress price. This price depression is, of course, more significant for small and medium cap companies than for large cap companies with greater liquidity.

There is currently much controversy surrounding so-called "naked short selling," about which Pollack also warned over two decades ago. Some companies, investors, and academics see naked short selling and the delivery failures that can result as harmful (and illegal) wealth destruction mechanisms. Skeptics claim that naked short selling, as an issue, is buoyed only by poor-performing companies and investors seeking a scapegoat for stock price declines.

Unfortunately, the drama associated with this clash has



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drawn attention away from the uncomfortable fact that illegal, unsettled trades are a large and growing problem in U.S. equity markets. Those unsettled trades threaten the corporate voting system, the viability of small companies, and market integrity as a whole. Large unsettled trades persist because of loopholes in stock market institutions and apathy on the part of those charged with enforcing existing regulations.

DEMATERIALIZATION AND SECURITIES ENTITLEMENTS

Physical stock certificates are an anachronism in modern stock markets. Today, stock ownership changes are reflected in electronic book-entry movements among broker-dealers' accounts at the Depository Trust Company (DTC), a central stock depository and member of the Federal Reserve System. The DTC acts as a custodian for the majority of securities issues.

The DTC emerged in response to the "paper crisis" of the 1960s, when stock transfer volume in the United States grew so large that issuers, transfer agents, exchanges, and brokerages were unable to process efficiently the paperwork associated with stock trades. The marketplace was overwhelmed by paper and timely transfer became impossible. The securities industry created the DTC in order to make stock transfer efficient and orderly.

The DTC modernized markets through "dematerialization": the transition from physical stock certificates to electronic bookkeeping. With dematerialization came major revisions to the Uniform Commercial Code in 1977, and later in 1994. Those revisions introduced "security entitlements" to our markets, which took the place of direct share ownership. Strictly defined, a security entitlement "guarantees an entitlement holder a priority in the financial assets held in [an] account over the securities intermediary or the security intermediary's creditors."

Today, investors trade in securities entitlements while physical certificates are held in "fungible bulk" at the DTC. As Erik Sirri, director of the SEC's Division of Trading and Markets, explained at a 2007 symposium on proxy processing:

> Broker participants in DTC own a *pro rata* interest in the aggregate number of shares of an issue held by DTC. And their beneficial owners, the end customer, owns an interest in the shares in which the brokers, themselves, have an interest. Consequently, there are no specific shares directly owned by either broker participants, DTC, or the underlying beneficial owner. As a result, the beneficial owner's ownership cannot be tracked to a specific share, but rather, his ownership interest is represented as a securities entitlement at his or her own broker dealer. Each of these beneficial owners don't own the actual shares that have been credited to their account, but rather, they own a bundle of rights defined by Federal and State law and by their contract with the broker.

That bundle of rights is represented by security entitlements in investor brokerage statements. Most investors, however, believe that a security entitlement is an electronic claim of ownership on a given number of shares of an issue. *That belief is incorrect.*

The DTC is a subsidiary of the Depository Trust and Clearing Corporation (DTCC), which acts as a central counterparty for U.S. exchanges and markets for equities, bonds, U.S. Government treasuries, and other securities. The DTCC manages the clearance and settlement system for U.S. equities through its subsidiary, the National Securities Clearing

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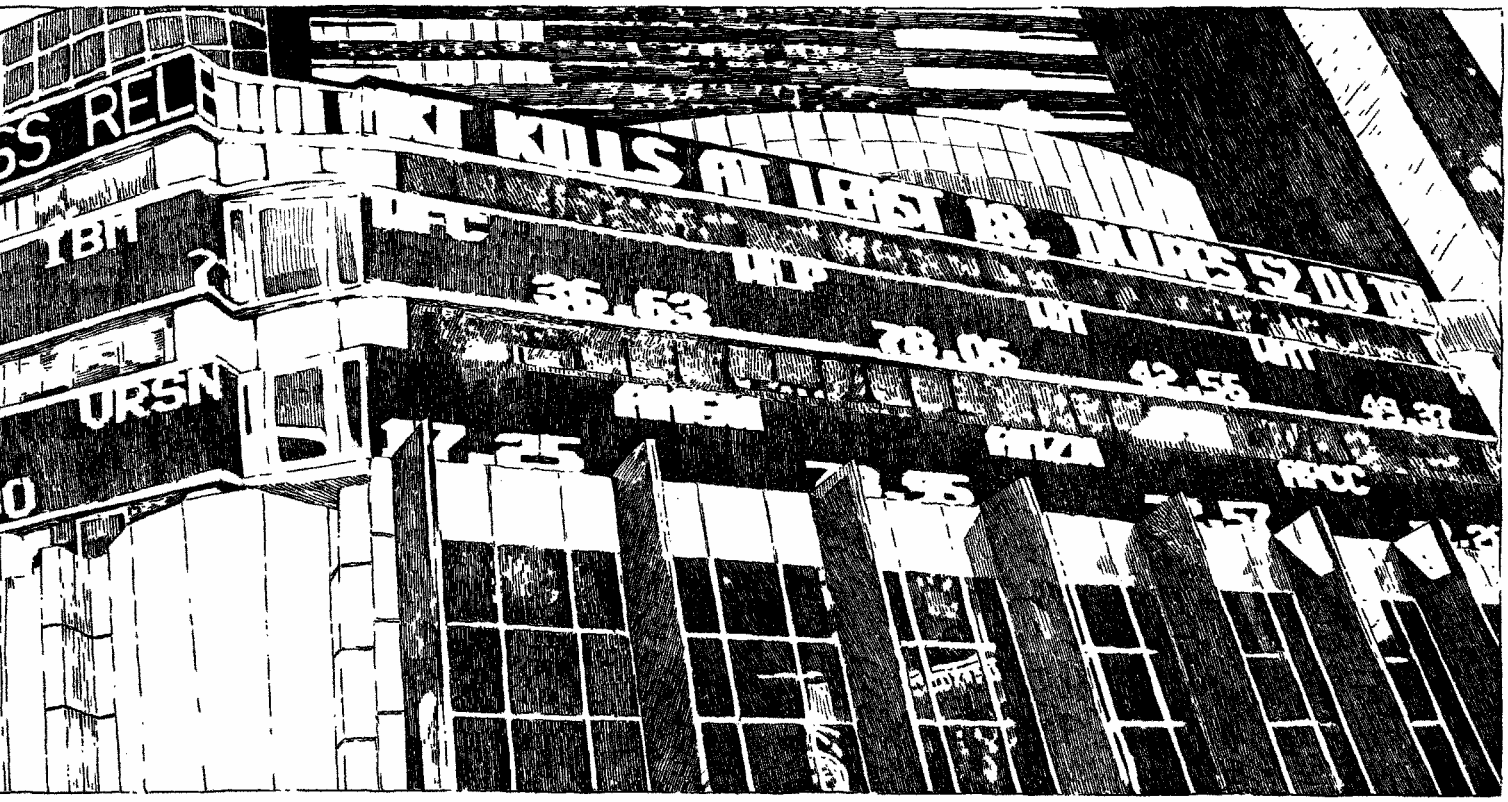


Corporation (NSCC). While physical payment and stock transfer occur within the DTC, it is the NSCC that provides final settlement instructions to customers and participant firms.

Table 1

Failures to Deliver on Major Exchanges (2006)

Exchange	Peak FTDs	Peak Date	Average Volume	FTDs as % of Average Volume
NYSE	172,707,364	31–Jan–06	1,701,643,478	10%
NASDAQ, OTCBB and pink sheets	1,337,784,073	13–Mar–06	15,455,938,738	9%

SOURCES: *SEC, Exchanges*

FAILS TO DELIVER

Short selling is a bet that a stock price will decline. A short seller borrows stock and then sells it, hoping to buy back the same amount of stock later, at a lower price, for return to the lender. Though sometimes controversial, short selling is a legal and vital source of liquidity and efficient price discovery. Executing short sales without borrowing or delivering shares, however, can lead to delivery failures.

Naked short selling involves selling without first borrowing stock (or even locating stock to borrow). If a naked short seller does not borrow the stock he sells, he will be unable to deliver that stock to the buyer to settle the trade. Intentional naked short selling is illegal, though market makers are currently allowed to naked short temporarily when engaged in bona fide market making. (Even market maker FTDs, however, are illegal when delivery failure exceeds 13 days.)

In U.S. equity markets, settlement occurs within three days of a trade. In the case of both long and short sales, if shares are unavailable for delivery then the settlement process can be complicated by FTDs and "failures to receive" (FTRs). To the extent that FTDs and FTRs are only occasional and temporary, trade in security entitlements rather than physical shares helps to keep markets liquid and efficient.

Delivery failures are problematic, however, when they are large and persistent. In those situations, FTDs act as "phantom" or counterfeit shares that circulate in the system as real shares. Just as counterfeit currency dilutes and destroys value, phantom or counterfeit shares deflate share prices by flooding the market with false supply.

Retail brokerage customers generally never learn that they paid money for something that failed to be delivered to their accounts. That is because retail customers' brokerage account statements do not reveal whether delivery takes place; even when no shares are delivered at settlement, share entitlements are still credited to the buyer's account. Those credited share entitlements then trade in the market *as if they were real shares issued by the company.*

Though part of the Federal Reserve System, the DTCC is collectively owned and operated by the large U.S. brokerages. As a result, DTCC operations are technically overseen by the SEC. In fact, the DTCC operates with minimal SEC oversight. Until recently, the size of past (but not current) FTDs in given equity issues could only be obtained through petition to the SEC's Freedom of Information Act office, which must request the information, in turn, from the DTCC. This process took months and resulted in the release of stale market data. The SEC recently made available for Internet download limited FTD data for all securities listed on U.S. equity markets. As this article goes to print, however, only FTD data from the previous fiscal quarter are available (starting with August 2007). The DTCC claims to support limited disclosure of FTD data, but no additional data have been disclosed beyond that offered by the SEC.

The data released through Freedom of Information Act requests reveal that FTDs represent a significant percentage of average volume in the major exchanges and select issuers, as shown in Tables 1 and 2. The DTCC claims that FTDs and

Table 2

FTDs of Select Securities (2004–2006)

Issuer	Peak FTDs	Peak date	Average volume	FTDs as % of average volume	Shares outstanding on peak day	FTDs as % shares outstanding
Cal-Maine (CALM)	2,498,529	10–Jan–05	430,102	581%	23,682,000	10.55%
Global Crossing (GLBC)	2,387,641	21–Jan–05	660,604	361%	22,054,000	10.83%
iMergent (IIG)	289,054	2–May–05	303,852	95%	12,124,200	2.38%
Inhibitex (INHX)	3,129,627	7–Apr–06	20,738	15,091%	30,243,300	10.35%
Krispy Kreme (KKD)	4,652,372	28–Mar–05	4,359,081	107%	61,756,000	7.53%
Netflix (NFLX)	4,959,482	3–Jan–05	2,578,794	192%	52,732,000	9.41%
Novastar Financial, Inc. (NFI)	3,223,846	10–Nov–04	409,272	788%	6,357,000	50.71%
Overstock.com (OSTK)	3,800,172	20–Mar–06	932,835	407%	20,536,000	18.50%
Vonage (VG)	5,662,925	30–May–06	1,681,333	337%	154,727,000	3.66%

SOURCES: *SEC, Bloomberg*

FTRs sum to $6 billion daily, or 1.5 percent of the dollar volume. But that $6 billion is only the present ("marked to market") value of failed trades and perhaps represents just a fraction of the total problem. Because many failed trades go undelivered for months or years, they effectively depress prices by creating false supply.

Delivery failures are not confined to the equity markets. According to the Securities Industry and Financial Markets Association (SIFMA), at the end of the second quarter of 2007, NYSE member firms had over $42 billion in FTDs and $150 billion in FTRs. It is unclear what portion of those fails represents equities and what portion represents fixed income, derivatives, or other securities. The SIFMA Fails Working Group wants to develop a Standard Fail Report so that broker-dealers can effectively report fails to trade counterparties.

Table 3

Threshold List

Total number of days on the list, January 2005–January 2008

Days	# of Securities
13+	4164
25+	2695
50+	1478
100+	625
200+	172
400+	22
600+	4

SOURCE: *Buyins.net*

CNS In equity markets, the origin of FTDs is obscured by the Continuous Net Settlement (CNS) system, operated by the NSCC. The CNS constantly nets stock trades among broker-dealer accounts at the DTC. In a dematerialized world, the CNS allows trades to settle promptly and efficiently, and helps to provide liquidity when there are occasional and temporary FTDs. According to Sirri, through CNS the NSCC effectively "steps in between two parties to a trade and nets each party's obligation to trade over multiple trades, so that each obligation to receive or deliver, and an obligation to deliver or receive, can be combined together into one." He adds,

> If the broker fails to deliver to NSCC, NSCC allocates that fail using a random distribution algorithm to the broker that is due to receive securities of that issue. This innovation in netting process precludes identifying or tracking which specific customer or broker fails to receive shares. The broker that did not, in fact, receive securities because of this allocation will nonetheless credit the securities positions to his customer accounts even though no shares appeared in their DTC account. This creates an imbalance between the number of shares credited to the broker's DTC account and the number of shares credited to the broker's customer accounts.

By cloaking delivery failures in anonymity, CNS opens up the settlement system to abuse and fraud. Pollack remarked in 1986, "While the CNS system...has substantially increased the efficiency of the clearing process, the unlimited mark-to-the-market procedures also permit brokers to postpone delivery indefinitely, unless the purchasing broker initiates buy-in procedures." Forcing delivery and payment from trade counterparties through such buy-ins is, however, exceptionally rare in the stock market because of the resulting reputation effects. In a 2005 analysis of 69,000 stock transactions, economists Richard Evans, Christopher Geczy, David Musto, and Adam Reed found that buy-ins occurred only 0.12 percent of the time.

The DTCC asserts that CNS has "eliminated the need to settle 96 percent of total obligations." If the DTCC processes $400 billion in trades daily as claimed, then $384 billion are netted out and only $16 billion require delivery. In a 2005 letter to the DTCC, Robert Shapiro, former undersecretary of commerce for economics, observed that the $6 billion in FTDs that exist on any given day is 37.5 percent of the $16 billion in trades that require delivery—"*25 times* the 1.5 percent reported by the DTCC."

Notably, the FTD data do not include "ex-clearing" transactions—that is, trades cleared directly by brokers that bypass the DTCC. Those trades are also referred to as "non-CNS" in that they occur external to the NSCC and are reported differently. Neither the SEC nor the exchanges will disclose the names of the institutions failing to deliver on the grounds that "fails statistics of individual firms...is proprietary information and may reflect firms' trading strategies." That statement seems odd; what is proprietary about data on illegal trading activity? Moreover, how are FTD data more proprietary than short interest data, which are reported twice monthly?

REGULATION SHO

The little that is known publicly about FTDs is available as a result of Regulation SHO, implemented by the SEC in January 2005 to curb abusive naked short selling and reduce FTDs. Regulation SHO requires exchanges to publish daily lists of firms with FTDs that exceed a pre-determined threshold. That list is known as the Regulation SHO Threshold List. According to SEC chairman Christopher Cox,

> The need for Regulation SHO grew out of long-standing and growing problems with failures to deliver stock by the end of the standard three-day settlement period for trades.... Selling short without having stock available for delivery, and intentionally failing to deliver stock within the standard three-day settlement period, is market manipulation that is clearly violative of the federal securities laws.

According to the SEC, 11,345 securities have "graduated" from Threshold Lists since January 10, 2005, "representing 8.2 billion shares in fails." Public data aggregated from the exchanges reveal that 6,555 unique securities have appeared on Threshold Lists since Regulation SHO was adopted (there are roughly 15,000 total publicly traded equity issues in the United States). Thus, as shown in Table 3, many companies have been on the Threshold List more than once; some have been on for hundreds of trading days, belying the SEC's 13-day settlement rule.

In response to questions submitted by the House Financial Services Committee in June of 2007, the SEC claimed that Regulation SHO had reduced fails. The SEC compared a pre-Regulation SHO period (April 1, 2004 to December 31, 2004) to a post-Regulation SHO period (January 1, 2005 to May 31, 2007) for all stocks with aggregate FTDs of 10,000 shares or

more as reported by the NSCC. In that period, the SEC found:

- The average daily aggregate FTDs declined by 27.0 percent.
- The average daily number of FTD positions declined by 14.0 percent.
- The average daily number of threshold securities declined by 38.0 percent.
- The average daily fails of threshold securities declined by 50.8 percent.

However, the SEC's choice of time periods was selective, and appears to mask what subsequent data show is a serious and growing problem. First, the SEC's assertion that aggregate FTDs are decreasing is false. As depicted in Figure 1, NSCC data on aggregate fail-to-deliver positions across the New York Stock Exchange, NASDAQ, bulletin boards, and pink sheets show that fail levels are highly volatile and, on the whole, increasing.

By comparing the average of this time period with the average of the pre–Regulation SHO time period, the SEC appears to make a statistical error. To see this, consider the incentives faced by broker-dealers and other market participants with large FTD positions pre–Regulation SHO. The final rule was announced on July 28, 2004, with a compliance date of January 3, 2005. Without knowledge of how Regulation SHO would be enforced, it is likely that those firms tried to reduce fails in the SEC's pre-Regulation SHO comparison period (April 1, 2004 to December 31, 2004). Once it was clear that enforcement would be minimal and compliance unnecessary, fails increased again in 2005. That scenario yields FTD averages consistent with both the SEC's claims and the recent increase in fails.

Second, not only have the aggregate FTDs in the system increased in the face of Regulation SHO, but FTD positions in certain public companies have grown large and persistent. That finding is consistent with a 2005 paper by University of New Mexico finance professor Leslie Boni, who researched the FTD issue for the SEC and found that fails were concentrated in hard-to-borrow stocks. Pollack wrote that the same was true 20 years ago: "When extensive short selling occurs, stock is not readily available and sometimes cannot be borrowed at all. In these cases, the incentive to deliver securities is substantially less, and there may be an incentive to avoid or postpone delivery."

LOOPHOLES

Serious loopholes in Regulation SHO have perpetuated settlement failures. In a 2006 public hearing, Cox spoke candidly of "abusive naked short sales...which can be used as a tool to drive down a company's stock price to the detriment of all of its investors. The Commission is particularly concerned about persistent failures to deliver in the market for some securities that may be due to loopholes in the Commission's Regulation SHO."

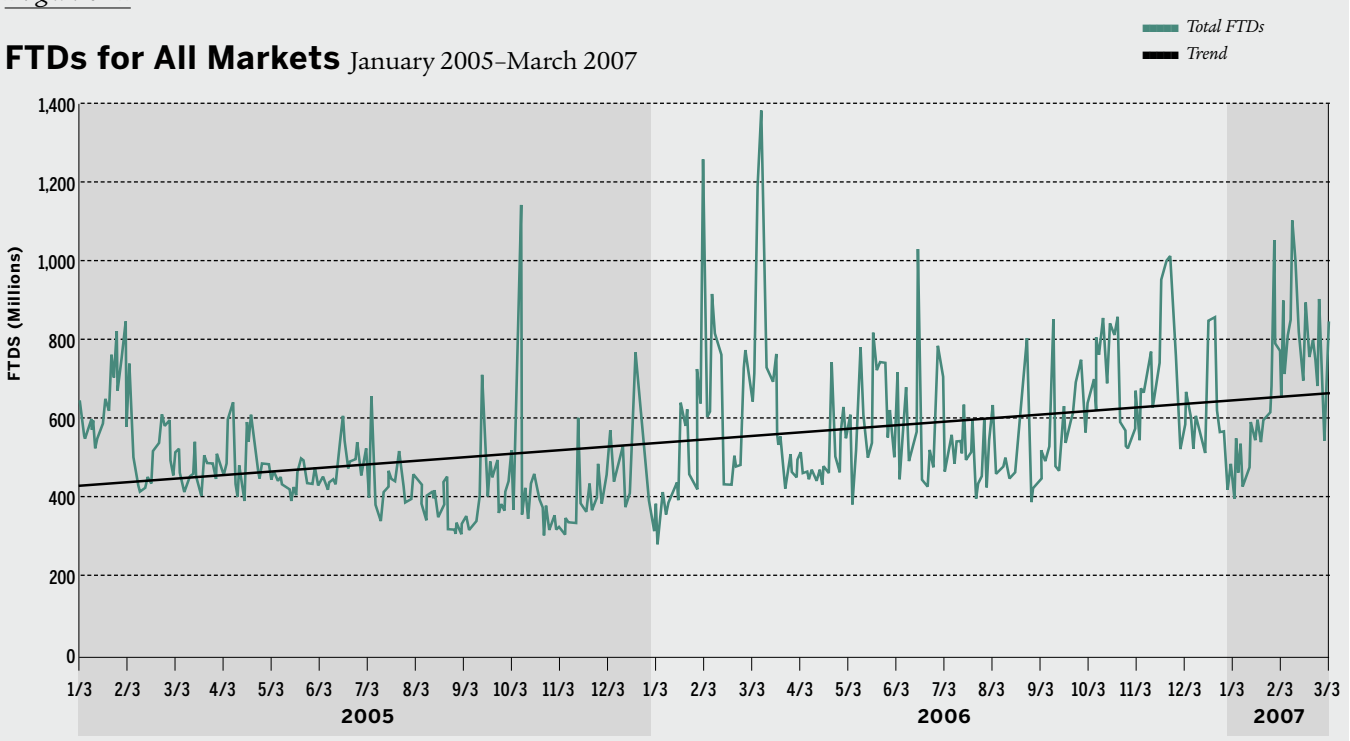
GRANDFATHERING One such loophole is Regulation SHO's "grandfathering" of FTDs that occurred prior to January 2005. The regulation also allows FTDs that do not remain open long enough for the issuer to appear on the Threshold List.

The SEC voted to eliminate the grandfather clause in August 2007. That rule change became effective December 5, 2007.

OPTIONS MARKET MAKER EXCEPTION The second loophole is the options market maker exception. In theory, stock markets are made more efficient by intermediaries who "make

Figure 1

FTDs for All Markets January 2005–March 2007



SOURCE: *"SHO Underperforms in Reducing Fails," by David Patch. June 27, 2007.*

markets" in order to smooth price and volume fluctuations. A market maker poses as a buyer or a seller, acting as a temporary counterparty when needed to create market liquidity. Ideally, market maker positions last minutes or hours; generally, positions are closed out at the end of each day. In the process of making markets, market makers may temporarily need to sell stock they do not have. For this reason, Regulation SHO has allowed options market makers an "exception from the uniform 'locate' requirement...for short sales executed by market makers...including specialists and options market makers, but only in connection with bona-fide market making activities."

Not surprisingly, market participants have abused this exception. There is clear evidence that, when shares in a stock are hard to borrow, sophisticated short sellers illegally "rent" the exception in order to obtain phantom shares that they can sell into the market as real shares. For example, in July 2007 the American Stock Exchange disciplined two options market makers for precisely this violation of Regulation SHO; aggregate fines and penalties totaled $8 million.

In response to overwhelming evidence of abuse, the SEC proposed amending Regulation SHO to narrow or eliminate the options market maker exception in August 2007. The SEC writes:

> We are concerned that persistent fails to deliver will continue in certain equity securities unless the options market maker exception is eliminated entirely....The ability of options market makers to sell short and never have to close out a resulting fail to deliver position, provided the short sale was effected to hedge options positions created before the security became a threshold security, runs counter to the goal of similar treatment for fails to deliver resulting from sales of securities and may have a negative impact on the market for those securities.

In the proposed amendment, the SEC suggests that the options market maker exception has been misread and abused:

> [T]he current options market maker exception only excepts from Regulation SHO's mandatory 13 consecutive settlement day close-out requirement those fail to deliver positions that result from short sales effected by registered options market makers to establish or maintain a hedge on options positions established before the underlying security became a threshold security. Thus, it does not apply to fails to deliver resulting from short sales effected to establish or maintain a hedge on options positions established after the underlying security became a threshold security.

Moreover, the SEC admits that the exception is being used improperly to roll failed positions:

> [It] has become apparent to us during the comment process that the language of the current exception is being interpreted more broadly than the Commission intended, such that the exception seems to be operating significantly differently from our original expectations.... For example, options market makers' practice of "rolling" positions from one expiration month to the next potentially allows these options market makers to not close out fail to deliver positions as required by the close-out requirements of Regulation SHO.

Though the comment period for the proposed elimination officially ended in September of 2007, comments are still being accepted by the SEC and no action has been taken.

LOCATE REQUIREMENT Another crucial loophole in Regulation SHO lies in the nebulous wording of the "locate" requirement, which allows a broker-dealer to execute a short sale with only "reasonable grounds to believe that the security can be borrowed so that it can be delivered." The locate requirement originated with SEC proposed rule 10b-21 (1973), which said one "had to borrow or have reasonable grounds to believe the stock could be borrowed" prior to effecting a short sale. That rule was withdrawn, but the concept later evolved into NASD Rule 3370, which requires that "prior to accepting a short sale order...a member must make an affirmative determination that the member will receive delivery of the security from the...broker-dealer or that the member can borrow the security on behalf of the...broker-dealer for delivery by the settlement date." This vague standard makes meaningful enforcement nearly impossible; the "reasonable grounds" condition is easy to meet and difficult for a prosecutor to refute.

Regulation SHO includes important exceptions to the locate requirement. Besides the options market maker exception discussed above, there is an exception for stocks on so-called "easy-to-borrow" lists. Regulation SHO states:

> "Easy to Borrow" lists may provide "reasonable grounds" for a broker-dealer to believe that the security sold short is available for borrowing without directly contacting the source of the borrowed securities. In order for it to be reasonable that a broker-dealer rely on such lists, the information used to generate the "Easy to Borrow" list must be less than 24 hours old, and securities on the list must be readily available such that it would be unlikely that a failure to deliver would occur.... [R]epeated failures to deliver in securities included on an "Easy to Borrow" list would indicate that the broker-dealer's reliance on such a list did not satisfy the "reasonable grounds" standard of Rule 203.

Broker-dealers also create "hard-to-borrow" lists, but "the fact that a security is not on a hard-to-borrow list cannot satisfy the 'reasonable grounds' test" of Regulation SHO.

THE IMPACT OF FTDS

FTDs threaten market integrity in at least three ways:

- They undermine corporate voting mechanisms.
- They damage and destroy firms.
- They increase the possibility of systemic collapse.

On the first point, large and persistent FTDs lead to more claims of ownership than there are shares to own and vote,

resulting in chronic over-voting and undermining our corporate voting system. According to Sirri, "Hopefully, in time the broker who fails to deliver will deliver shares to DTC and correct the imbalance. If the broker does nothing to rectify this imbalance, the firm may ultimately end up casting more votes than actually he is entitled to vote based on the number of shares it has at DTC." Bob Drummond of *Bloomberg Markets Magazine* reported in April 2006, "In close contests with little room for error, the results of high-stakes company decisions may hinge on the invisible influence of millions of votes that shouldn't be counted." According to Thomas Montrone, CEO of Registrar and Transfer Co., "It is an abomination.... A lot of the time we have no idea who's entitled to vote and who isn't. It's nothing short of criminal." Another securities consultant notes, "There are votes cast twice on almost every matter of substance.... It definitely can and does, in my experience, affect the outcome of corporate elections and proposals."

Bloomberg Markets also reported on a review of proxy vote counts conducted by a large stock transfer agent in 2005. That review, originally made public by the Securities Transfer Association, a trade group for stock transfer agents, tabulated the results of all proxy votes submitted by banks and brokers in 2005. For 341 equity issues, attempted over-voting—the submission of too many ballots—occurred in all 341 cases. Arbitrageurs are exploiting this crack, suggests Drummond; one source notes, "It appears to be the case where there are opportunities to game the system." Drummond concluded that until these problems are fixed, "double and triple voting on one share will continue to make a mockery of shareholder democracy."

On the second point that companies and shareholder value are destroyed, former SEC chairman Harvey Pitt claims:

> Naked shorting harms the market and market participants, particularly when fails persist for substantial periods, as they clearly have. Naked short sellers effectively gain more leverage than if they were required to borrow securities and deliver within a reasonable period of time. And this additional leverage may be used to drive down a stock's price. In addition, naked shorting effectively dilutes the pool of real securities. Phantom shares created by naked shorting are analogous to counterfeit money. In a stock market corollary to Gresham's law, the more phantom shares of an issuer's stock that circulate, the more they drive out or devalue an issuer's real shares to the detriment of investors and issuers alike. Fails associated with naked shorting harm investors in other ways, for example, by depressing stock prices to the point that shares may not be marginable, denying shareholders the ability to borrow against them.

Boni shows that many FTDs are strategic—that is, concentrated in a subset of issues. The distribution of those failures is inconsistent with the hypothesis that they occur through random human error. As Boni put it diplomatically, persistent fails "are more likely the result of strategic fails rather than inadvertent delivery delays." That is, they are intentional. Because regulations are loose and (as we will see) enforcement is lax (and difficult), some market participants are apparently unafraid of intentionally failing to deliver.

Shapiro, who now is a consultant for lawyers representing some of the alleged victims of naked short selling mentioned above, said in a 2007 Bloomberg Television special report on unsettled trades that as many as 1,000 public companies were damaged by naked shorting prior to enactment of Regulation SHO:

> A lot of those companies are gone. A lot of them died. This was a fatal attack. Now, some of them were weak when they were attacked. Some of them would have failed anyway. Others wouldn't have. Again, it's not up to the naked short sellers to decide. It's up to the investors that play by the rules.

Skeptics argue that many (if not most) companies harmed by naked short selling suffer from performance problems or poor business models. The SEC's own "Key Points about Regulation SHO" contains this warning:

> There also may be instances where a company insider or paid promoter provides false and misleading excuses for why a company's stock price has recently decreased.... [T]hese individuals may claim that the price decrease is a temporary condition resulting from the activities of naked short sellers.... Often, the price decrease is a result of the company's poor financial situation rather than the reasons provided by the insiders or promoters.

Following the SEC's lead, the DTCC has responded to lawsuits from companies challenging its role in settlement failures by attacking those companies' financials. DTCC general counsel Larry Thompson writes, "According to their own 10K and 10Q reports financial auditor's disclosure statements, many of these firms have admitted that 'factors raise substantial doubt about the company's ability to continue as a going concern.' They have had little or no revenue...and substantial losses." Nevertheless, fraud and illegal manipulation are never justified, even in situations where an issuer has genuine performance problems.

Moreover, fails in thinly traded equity issues are far more toxic than fails in thickly traded treasuries or other securities. At a high enough concentration, such FTDs could threaten market integrity. Some 500 million shares remain unsettled at the DTCC on any given day. Bradley Abelow, a former DTCC director questioned under oath for confirmation as New Jersey treasurer, described failures within the settlement system as "occur[ing] as a matter of course with great regularity," adding "fails to deliver of securities is endemic." Boni describes the FTDs as "pervasive." In fact, according to the SEC, "The grandfathering provisions of Regulation SHO were adopted because the Commission was concerned about creating volatility where there were large pre-existing open positions." That concern may have been justified. If FTDs result in more claims of ownership than physical shares of an issue, what happens when fail data are made public? What happens if the fail data reveal that the imbalance exceeds the liquidity in the system?

REGULATORY FAILURE

On the topic of "massive naked short sales," Shapiro writes:

> [T]his type of stock manipulation has occurred in many hundreds and perhaps thousands of cases over the last decade.... Illicit short sales on such a scale or anything approaching it point to grave inadequacies in the current regulatory regime.

The answer to why these "grave inadequacies" exist lies in the structure of the SEC, in the design of the rule-making process, and in the incentives faced by SEC staff.

The SEC Division of Trading and Markets (formerly the Division of Market Regulation) provides daily oversight of major securities market participants, including exchanges and self-regulatory organizations, broker-dealers, clearing agencies, stock transfer agents, proxy processing services, and credit rating agencies. The Division of Trading and Markets also proposes and adopts new SEC rules. Rule proposals go through three stages:

- ***Concept release***, where the SEC describes a general area of interest and asks for guidance from the public.
- ***Rule proposal***, where the SEC puts forward a specific proposal and solicits formal comment from the public.
- ***Rule adoption***, where the SEC considers the public comments and formulates the final rule.

If all five SEC commissioners vote to adopt the rule then it becomes regulation and is incorporated into the *Federal Register*.

The 2003 SEC short sale rule proposal was broad and instructive. The proposal provided historical context for short sale rules (including the now-eliminated "tick test"), short sales in connection with a public offering (Rule 105), short/long order marking requirements, market making and rule exceptions, and preconditions for effecting short sales. The proposal asked for public comment on short sale abuses and delivery failures connected with naked short sales.

The Regulation SHO comment period lasted over six months, until July 2004. Public comments were divided and voluminous. The broker-dealer community, both individually and through its trade group, the Securities Industry Association (now SIFMA), favored a permissive regulatory regime that refrained from punishing those who failed to deliver on the grounds that such leniency would maximize liquidity. In addition to submitting letters, SIFMA organized conference calls and meetings with SEC staff. Retail investors and members of the general public, on the other hand, submitted passionate but generally less polished opposing views. For reasons unknown, few issuers commented.

The contrast between SIFMA and retail investors—and their relative influence over the SEC rulemaking process—reflects the classic dispersed costs and concentrated benefits model of political action. It is economical for broker-dealers to unite and lobby the SEC for favorable regulations. SIFMA meets with SEC staff regularly, both to discuss specific proposed rules and to offer guidance on future SEC actions. Retail investors, on the other hand, are not unified and it is expensive for individuals to gather information, organize, and lobby the SEC as the SIFMA does.

Not surprisingly, the grandfather clause and the options market maker exception were suggested by SIFMA members and the options exchanges, respectively. No members of the public had opportunity to comment on those "loopholes" before they were made law. Furthermore, the original Regulation SHO proposal suggested penalties for failing to deliver. After strident objections by SIFMA-member firms, that proposal was dropped.

Though there are loopholes, Regulation SHO is not as nugatory as some critics maintain. The regulation clearly states that fails must be closed out after 13 days and even options market makers may not fail in issues with enough FTDs to be on the Threshold List. Regulation SHO also has clear reporting and order marking requirements. Enforcement of even those watered-down rules has been weak, however. The SEC itself acknowledges that rule violations are extant, but in response to the 2007 review by the House Financial Services Committee the Commission admitted that, "To date, there have been no Commission enforcement actions announced involving Regulation SHO."

The exchanges have taken some action. In July 2007, the American Stock Exchange fined two options market makers for Regulation SHO violations. The year before, the New York Stock Exchange brought four Regulation SHO enforcement actions, censuring and fining Daiwa Securities America, Goldman Sachs Execution and Clearing, Citigroup Global Markets, and Credit Suisse Securities (USA) for operational deficiencies and supervisory violations concerning Regulation SHO. The cases resulted in total fines of just $1.25 million.

Notably, those cases focused on the actions of the broker-dealers and not their clients. For example, Goldman Sachs Execution and Clearing was sanctioned for repeatedly accepting clients' faulty locates and allowing those clients to mis-mark short trades as long (in order to avoid compliance with Regulation SHO). But the stock exchanges' jurisdiction extends only to member firms. Institutions and investors fall outside of that jurisdiction, but within the purview of the SEC, whose inaction therefore shields institutions and investors.

Why has the SEC Enforcement Division taken no action when the SEC admits that there remain "large and persistent fail to deliver positions?" One explanation may be that certain provisions of Regulation SHO are too imprecise for meaningful enforcement. (For example, what is meant by a "reasonable grounds to believe" that a security can be borrowed prior to selling short?) Another hurdle is that Regulation SHO contains no mention of penalties for those who violate the rules. Those explanations, however, are belied by the NYSE and AMEX enforcement decisions noted above. Those decisions followed the text of Regulation SHO and found violations so flagrant that even brokers acting on behalf of clients were sanctioned.

It is also possible that, in the wake of prominent fraud and accounting scandals, the Enforcement Division has become focused on issuers and largely ignores broker-dealer misconduct. That would be ironic given that the 1933 Pecora Hearings (which predated the 1933 Securities Act and the

1934 Securities and Exchange Act) expressly investigated the actions of brokers and speculative investment "pools," which were notorious fonts of long- and short-side market manipulation, including both penny stock scams and "bear raids."

Institutional inertia may also be a factor. A recent Government Accountability Office report revealed serious operational flaws in the SEC's Enforcement Division and the Office of Compliance, Inspection, and Examination. As Sen. Chuck Grassley (R-Iowa) summarized in a September 2007 memorandum:

> The GAO report...found that two-thirds of the SEC's cases had been open for more than two years, one-third had been open for more than five years, and 13 percent had been open for more than 10 years. Many of these cases "had not resulted in an enforcement action and were no longer being actively pursued," according to the GAO. The GAO also found that the SEC's system for tracking cases was "severely limited and virtually unusable."

A more sinister explanation is that SEC investigators face political pressure and other incentives not to pursue Regulation SHO cases. The GAO report was requested by the Senate Judiciary Committee, which was investigating serious allegations of misconduct and corruption in the firing of former SEC attorney Gary Aguirre. Prior to his dismissal, Aguirre led an insider trading investigation that implicated Pequot Capital and led to John Mack, CEO of Morgan Stanley. When Aguirre tried to subpoena Mack, the investigation was terminated. Aguirre's superior, branch chief Robert Hanson, said in an e-mail that the investigation would be problematic because Mack's legal counsel had "juice." Shortly thereafter, Aguirre was fired.

In May of 2006, Aguirre wrote ranking members of the Senate Finance Committee, describing serious oversight problems at the SEC and the return of 1920s-style speculation to the American capital markets. Aguirre also described how naked short selling emerged as an important component of his investigation into Pequot and Morgan Stanley:

> The [market manipulation] prong of the investigation involved two classes of suspected violations: wash sales and naked shorts. Some of my colleagues believed this prong held a greater potential to severely injure the capital markets. Evidence indicated that hedge funds used wash sales to spike stock prices just as unregulated pools used wash sales to spike stock prices in the 1920s. The investigation of both wash sales and naked shorts led to the hedge fund's prime broker, a large investment bank.

After an extensive investigation and several public hearings, the Senate Finance and Judiciary Committees issued a joint 711-page report that confirmed all of Aguirre's claims. The report criticizes the SEC for its failure to act in the face of clear evidence that Pequot and Morgan Stanley had engaged in manipulative conduct. More importantly, the report excoriates the SEC's Office of the Inspector General (OIG), which is tasked with evaluating the SEC's "compliance with policies, procedures, laws, or regulations":

> The OIG investigation into Aguirre's allegations was flawed from the beginning and hindered by missteps during the entire process.... One of the major problems with the OIG seems to be the perception within the SEC regarding the independence of the office and whether or not employees who approach the OIG are treated fairly. The SEC needs to take immediate action to restore the independence, competence, and confidence in the OIG. One area in need of attention is the OIG's independence from SEC management.... [F]acts and circumstances do not suggest a sufficient degree of independence.... Congress passed the IG Act in 1974, with the goal of ensuring that the public would have faith in government by providing an impartial arbiter tasked with independently overseeing the operations at an agency, protecting the integrity and promoting the efficiency of government.... [T]he OIG at the SEC seems to have failed in its mission.

Walter Stachnik, the first and only SEC inspector general at that time, resigned the day after the report's release.

On March 4, 2008, the SEC proposed a new anti-fraud rule directed at "misrepresentations in connection with a seller's ability or intent to deliver securities by settlement date." In theory, the rule would offer the SEC Enforcement Division additional tools to curtail manipulative naked short selling and the delivery failures that can result. The rule proposal is now in a public comment period. It remains to be seen what the final text of the rule will be and how it will be enforced.

CONCLUSION

Unless action is taken to reform regulations governing the settlement system, unsettled trades will multiply. As they do, voting will be further corrupted, companies will be destroyed, and the pre-conditions for a systemic event will be fed.

Unfortunately, the impetus for reform will not come from the securities industry itself. Hedge funds and the prime brokers that serve those funds benefit from unconstrained naked short sales. Hedge funds benefit because they can short without paying to borrow stock first. Prime brokers benefit by loaning out the same securities multiple times to different clients. As of the third quarter of 2007, hedge fund assets were $2.68 trillion and growing, as was the demand for shares to borrow. Securities lending generates $16 billion annually, and prime brokerage is among the most lucrative businesses for broker-dealers.

Harvey Pitt recommends the following to solve the FTD problem:

- The SECs needs actively to pursue ongoing chronic and serial short selling infractions.
- Meaningful penalties have to be imposed for violations of existing Regulation SHO requirements.
- The SEC should define and punish abusive naked short selling practices as securities fraud.
- The SEC should eliminate the option market maker exception. It is not demonstrably of any value, and it

risks facilitating illegal activity.

- Regulation SHO should impose firm locate requirements as a condition precedent to all short sales.
- Chronic and unjustified violations of settlement rules should be punished.
- Exchanges in other markets should be required to report the securities on daily Threshold Lists and aggregate daily volume of fails for each such security.

Numerous economists, the U.S. Chamber of Commerce, members of Congress, public companies, and hundreds of retail investors have urged the SEC to amend and enforce provisions of Regulation SHO. Whether the SEC will close the loopholes giving vague license to a highly profitable crime is yet to be determined. To borrow a phrase from Sen. Daniel Patrick Moynihan, the SEC has an unfortunate record of "defining deviancy down"—that is, making rules to accommodate existing market practices, regardless of how offensive those practices may be to law or common sense.

The SEC and the DTCC defend occasional naked short selling and delivery failures on the grounds that they foster "liquidity." Such arguments reveal that these regulators and professionals have forgotten that a price is a mixture of scarcity, risk, and value; unlimited liquidity obliterates scarcity and undermines the price system. As William Donaldson, Pitt's successor as chairman of the SEC, once remarked, "How much fraud are you willing to tolerate for liquidity? I think the answer is zero." R

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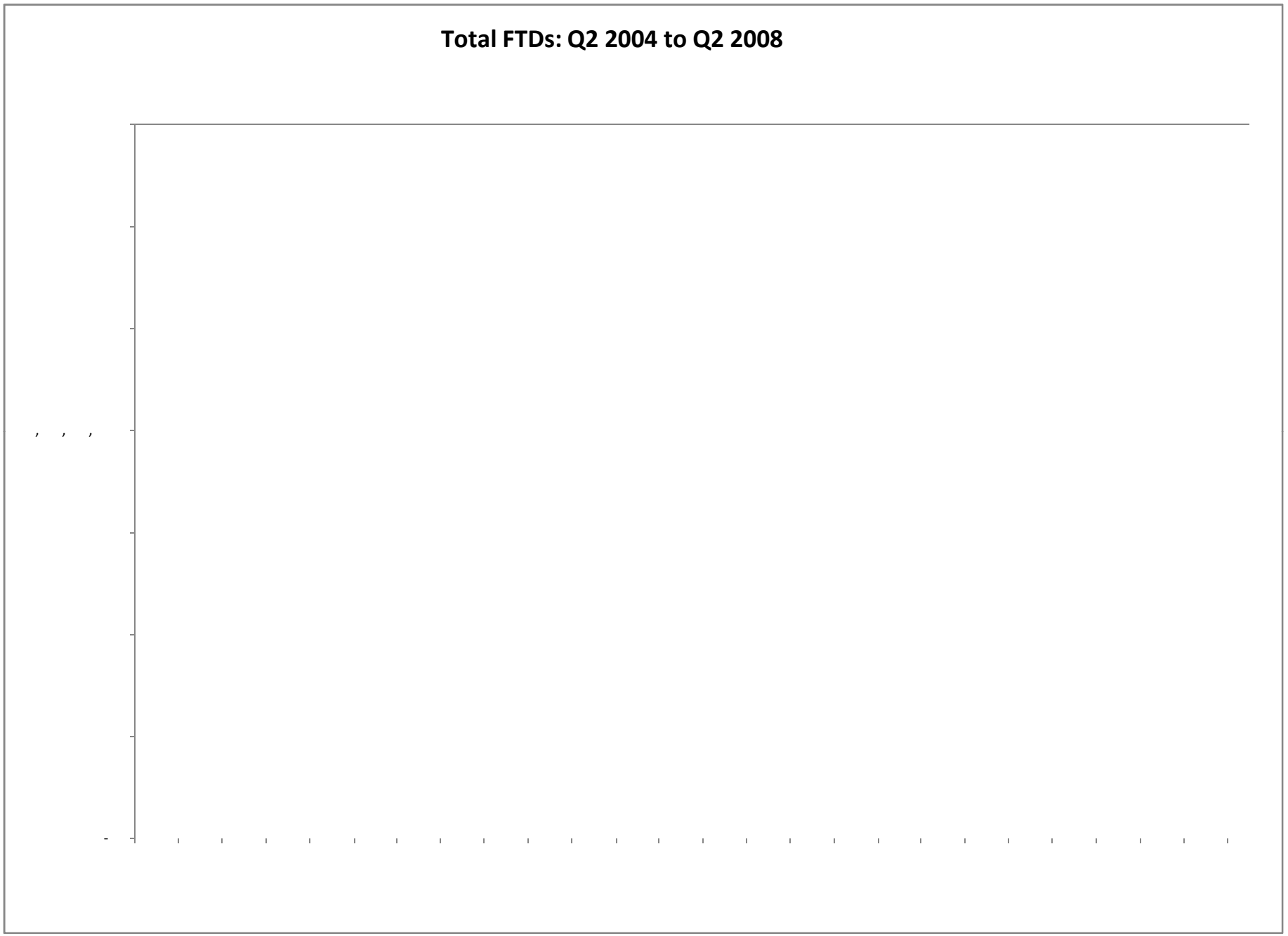
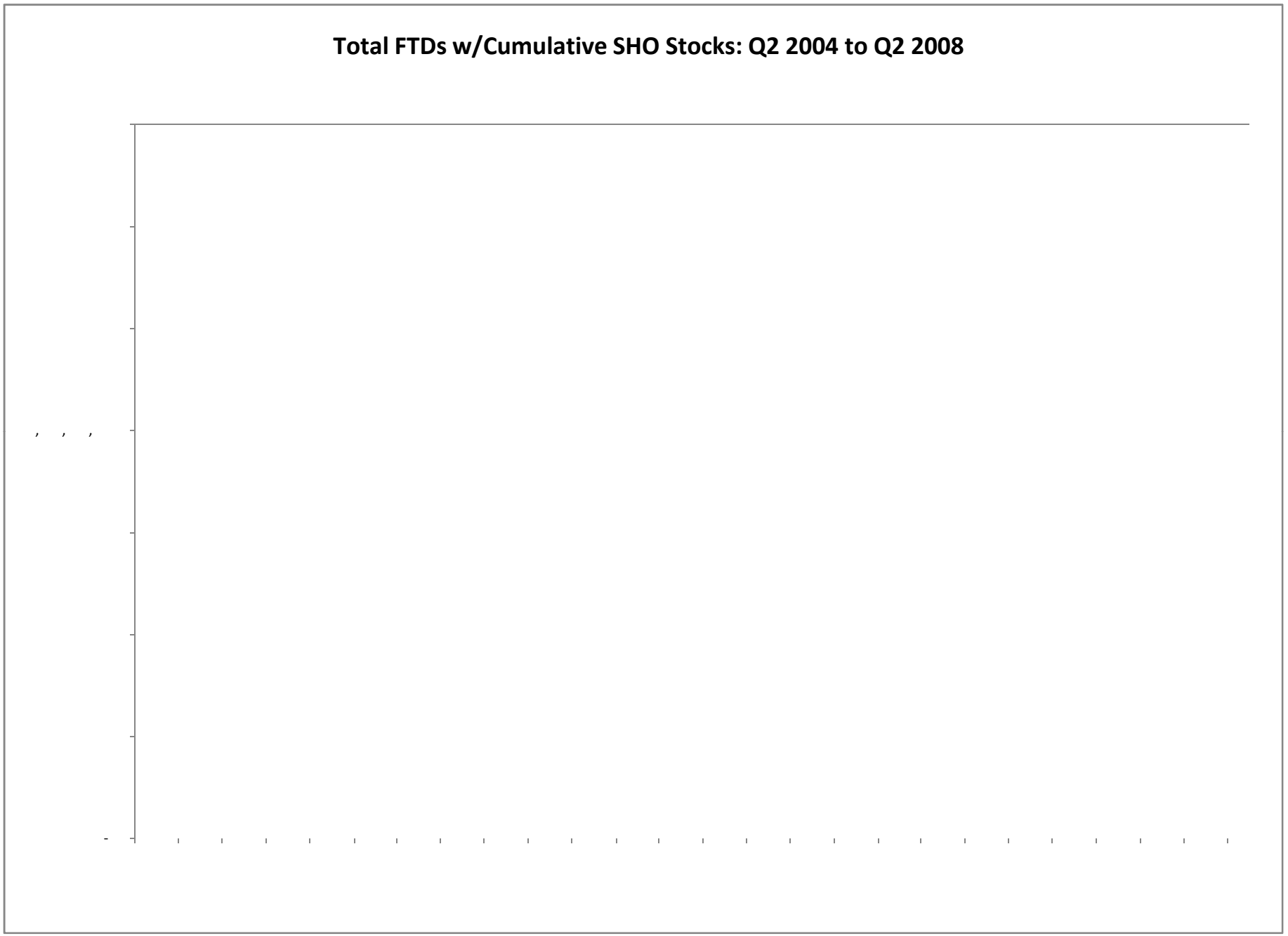
Total FTDs: Q2 2004 to Q2 2008



SOURCE: SEC FOIA Office, Bloomberg, CSI Data, FinancialContent, MarketWatch and Dow Jones.

Total FTDs w/Cumulative SHO Stocks: Q2 2004 to Q2 2008



SOURCE: SEC FOIA Office, Bloomberg, CSI Data, FinancialContent, MarketWatch and Dow Jones.

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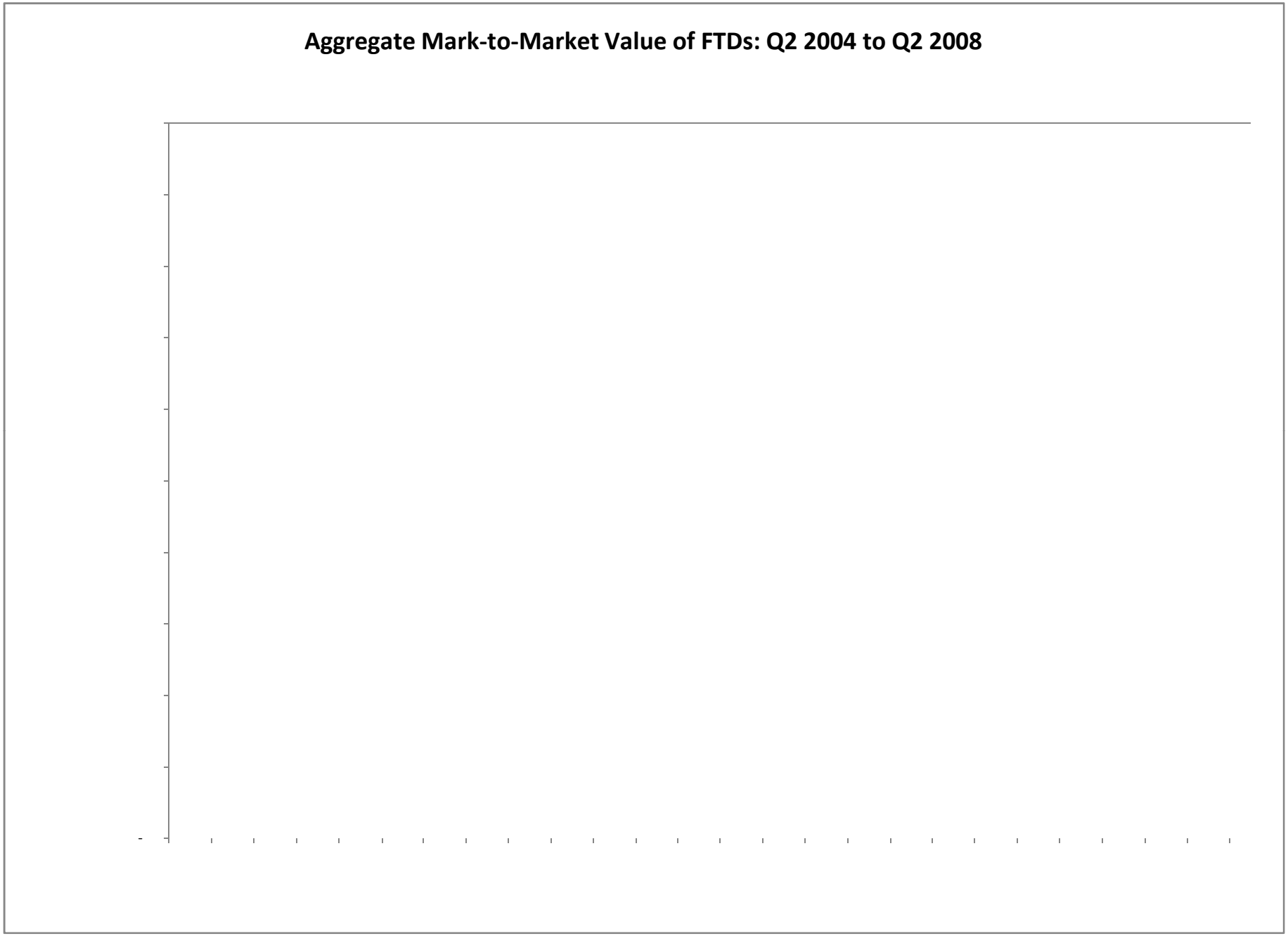
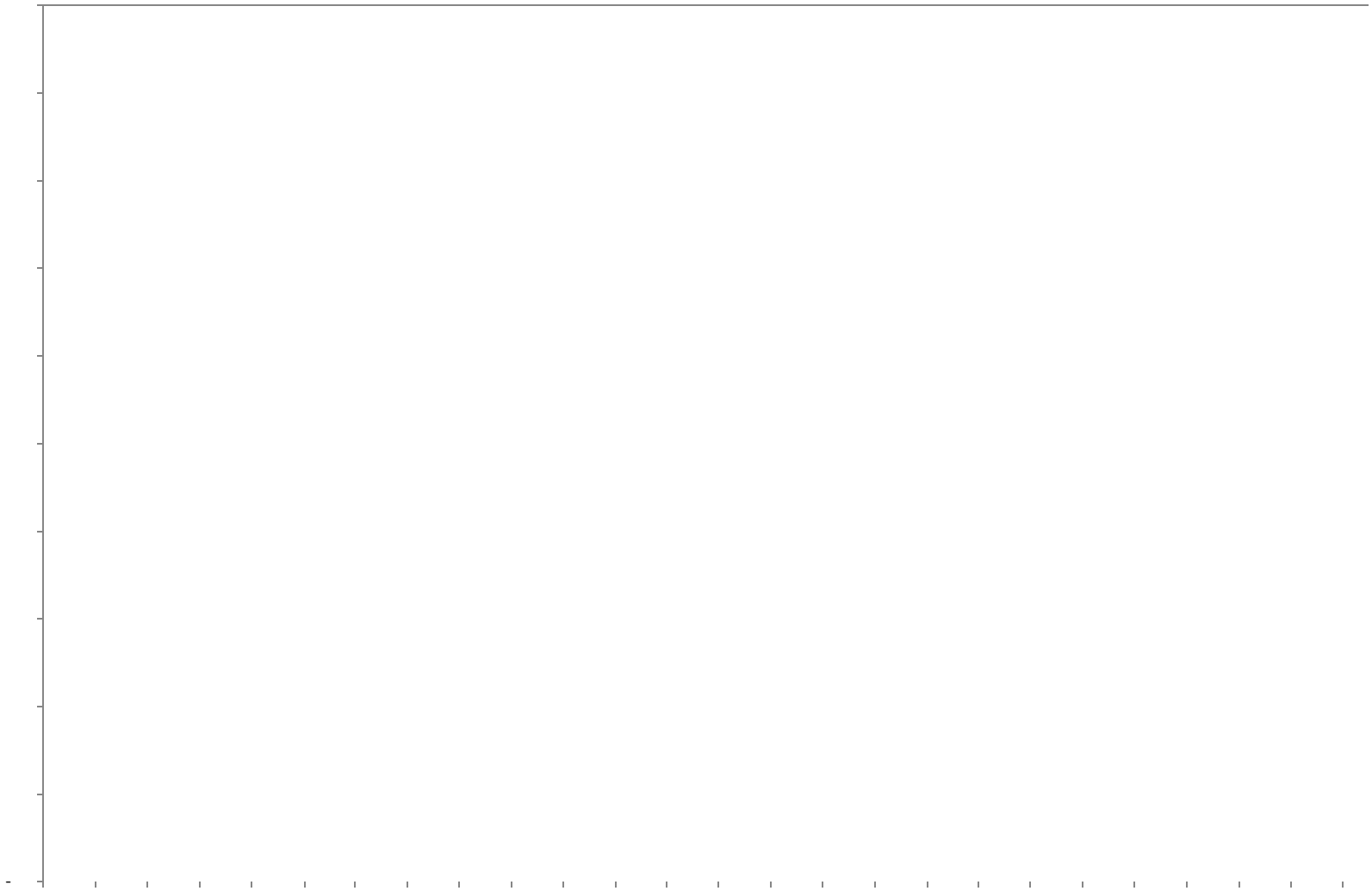
Aggregate Mark-to-Market Value of FTDs: Q2 2004 to Q2 2008



SOURCE: SEC FOIA Office, Bloomberg, CSI Data, FinancialContent, MarketWatch and Dow Jones.

Aggregate Mark-to-Market Value of FTDs w/Cumulative SHO Stocks: Q2 2004 to Q2 2008



SOURCE: SEC FOIA Office, Bloomberg, CSI Data, FinancialContent, MarketWatch and Dow Jones.

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Peak FTDs and FTD Dollar Value Days Across All Markets

Q	Date	Peak Total FTDs Value	SHO FTDs Value	% of Total	Cumulative SHO Stock FTDs Value	% of Total
Q2 '04	29-Jun-04	$5,577,176,767				
Q3 '04	17-Aug-04	$5,440,813,390				
Q4 '04	22-Dec-04	$6,718,581,803				
Q1 '05	22-Mar-05	$7,557,927,560	$1,217,975,735	16.12%	$3,475,608,887	45.99%
Q2 '05	21-Jun-05	$8,442,478,743	$1,139,398,242	13.50%	$7,093,831,472	84.03%
Q3 '05	20-Sep-05	$4,367,847,046	$1,786,508,560	40.90%	$3,170,640,331	72.59%
Q4 '05	16-Nov-05	$6,316,617,910	$1,034,322,029	16.37%	$1,993,022,595	31.55%
Q1 '06	31-Jan-06	$12,427,219,751	$1,842,307,158	14.82%	$3,448,084,502	27.75%
Q2 '06	24-May-06	$6,103,420,040	$1,608,932,325	26.36%	$4,355,252,698	71.36%
Q3 '06	05-Jul-06	$6,257,848,281	$3,662,802,142	58.53%	$4,718,868,171	75.41%
Q4 '06	19-Dec-06	$7,280,874,770	$1,759,217,926	24.16%	$5,836,666,454	80.16%
Q1 '07	20-Mar-07	$12,961,947,696	$4,719,666,198	36.41%	$11,494,496,282	88.68%
Q2 '07	27-Jun-07	$19,478,624,808	$2,355,541,740	12.09%	$17,348,522,042	89.06%
Q3 '07	31-Jul-07	$14,075,137,615	$2,638,863,763	18.75%	$11,420,014,977	81.14%
Q4 '07	21-Nov-07	$12,894,293,922	$2,895,180,783	22.45%	$10,249,059,239	79.49%
Q1 '08	26-Mar-08	$13,949,640,820	$4,477,260,022	32.10%	$10,470,026,409	75.06%
Q2 '08	25-Jun-08	$14,865,284,245	$8,383,502,823	56.40%	$12,772,720,886	85.92%

Date	Peak Total FTDs	Total SHO FTDs	% of Total	Cumulative SHO Stock FTDs	% of Total
08-Apr-04	826,445,950				
30-Aug-04	2,047,769,844				
07-Oct-04	1,452,578,505				
01-Feb-05	885,321,877	237,218,660	26.79%	324,424,955	36.64%
11-Apr-05	672,809,608	159,984,741	23.78%	463,421,352	68.88%
16-Sep-05	743,547,552	173,304,105	23.31%	282,011,315	37.93%
23-Dec-05	809,854,157	289,825,132	35.79%	685,123,052	84.60%
13-Mar-06	1,418,758,666	505,729,304	35.65%	1,012,627,076	71.37%
20-Jun-06	1,067,376,722	272,878,148	25.57%	514,333,299	48.19%
14-Sep-06	884,839,905	96,984,932	10.96%	779,701,828	88.12%
27-Nov-06	1,035,876,800	212,086,601	20.47%	713,540,014	68.88%
13-Feb-07	1,133,708,473	357,090,513	31.50%	646,940,780	57.06%
19-Jun-07	1,490,067,146	328,514,423	22.05%	780,382,456	52.37%
31-Jul-07	1,763,238,616	966,766,668	54.83%	1,326,104,330	75.21%
15-Nov-07	1,257,665,858	464,025,263	36.90%	1,019,691,622	81.08%
13-Mar-08	1,458,587,318	831,785,260	57.03%	1,167,348,044	80.03%
27-May-08	2,108,758,934	509,149,215	24.14%	853,023,116	40.45%

SOURCE: SEC FOIA Office, Bloomberg, CSI Data, FinancialContent, MarketWatch and Dow Jones.

Peak FTDs and FTD Dollar Value Days For Threshold Securities

Q	Date	Total FTDs Value	Peak SHO FTDs Value	% of Total
Q1 '05	03-Mar-05	$4,569,710,362.83	$2,211,996,554.95	**48.41%**
Q2 '05	29-Jun-05	$6,101,128,949.74	$3,166,315,631.63	**51.90%**
Q3 '05	06-Sep-05	$3,918,737,091.54	$2,426,296,510.17	**61.92%**
Q4 '05	12-Oct-05	$3,713,389,330.20	$1,763,105,493.44	**47.48%**
Q1 '06	31-Jan-06	$12,427,219,751.15	$1,842,307,158.11	**14.82%**
Q2 '06	22-May-06	$5,559,505,695.57	$2,946,868,038.36	**53.01%**
Q3 '06	05-Jul-06	$6,257,848,281.33	$3,662,802,142.32	**58.53%**
Q4 '06	20-Dec-06	$6,082,802,409.45	$1,858,545,833.40	**30.55%**
Q1 '07	22-Mar-07	$9,625,922,081.61	$5,882,850,833.73	**61.11%**
Q2 '07	31-May-07	$6,889,285,635.93	$4,305,585,107.82	**62.50%**
Q3 '07	01-Aug-07	$10,331,100,091.07	$3,851,289,677.35	**37.28%**
Q4 '07	26-Nov-07	$9,570,580,051.94	$4,194,998,920.94	**43.83%**
Q1 '08	25-Mar-08	$11,961,625,507.26	$4,490,707,226.14	**37.54%**
Q2 '08	25-Jun-08	$14,865,284,245.03	$8,383,502,823.21	**56.40%**

Date	Total FTDs	Peak SHO FTDs	% of Total
25-Feb-05	609,846,859	314,680,488	**51.60%**
28-Jun-05	602,622,675	329,186,829	**54.63%**
02-Aug-05	483,288,966	216,690,222	**44.84%**
28-Dec-05	554,781,870	301,457,753	**54.34%**
13-Mar-06	1,418,758,666	505,729,304	**35.65%**
30-May-06	781,541,128	360,002,799	**46.06%**
03-Jul-06	808,962,549	369,859,585	**45.72%**
29-Nov-06	833,634,172	473,602,994	**56.81%**
16-Feb-07	950,159,493	389,619,311	**41.01%**
25-Jun-07	1,081,464,423	420,329,081	**38.87%**
31-Jul-07	1,763,238,616	966,766,668	**54.83%**
31-Oct-07	1,121,602,703	741,357,524	**66.10%**
29-Feb-08	1,425,124,024	894,749,553	**62.78%**
01-Apr-08	1,183,192,614	605,744,672	**51.20%**

SOURCE: SEC FOIA Office, Bloomberg, CSI Data, FinancialContent, MarketWatch and Dow Jones.

Peak FTDs and FTD Dollar Value Days For Cumulative Threshold Securities

Q	Date	Total FTDs Value	Peak Cumulative SHO Stock FTDs Value	% of Total
Q1 '05	22-Mar-05	$7,557,927,559.84	$3,475,608,886.92	**45.99%**
Q2 '05	21-Jun-05	$8,442,478,742.96	$7,093,831,472.13	**84.03%**
Q3 '05	20-Sep-05	$4,367,847,046.42	$3,170,640,330.96	**72.59%**
Q4 '05	20-Dec-05	$5,509,638,514.12	$4,365,436,356.03	**79.23%**
Q1 '06	21-Mar-06	$7,471,023,796.74	$6,393,156,550.82	**85.57%**
Q2 '06	23-May-06	$5,734,603,954.81	$4,401,395,702.11	**76.75%**
Q3 '06	05-Jul-06	$6,257,848,281.33	$4,718,868,171.29	**75.41%**
Q4 '06	19-Dec-06	$7,280,874,769.87	$5,836,666,453.74	**80.16%**
Q1 '07	20-Mar-07	$12,961,947,696.19	$11,494,496,282.02	**88.68%**
Q2 '07	27-Jun-07	$19,478,624,807.65	$17,348,522,042.11	**89.06%**
Q3 '07	31-Jul-07	$14,075,137,615.39	$11,420,014,977.28	**81.14%**
Q4 '07	21-Nov-07	$12,894,293,922.44	$10,249,059,238.66	**79.49%**
Q1 '08	26-Mar-08	$13,949,640,819.56	$10,470,026,408.50	**75.06%**
Q2 '08	25-Jun-08	$14,865,284,245.03	$12,772,720,886.00	**85.92%**

Date	Total FTDs	Peak Cumulative SHO Stock FTDs	% of Total
28-Feb-05	633,601,875	455,435,886.00	**71.88%**
11-Apr-05	672,809,608	463,421,352.00	**68.88%**
26-Jul-05	518,641,121	371,228,244.00	**71.58%**
23-Dec-05	809,854,157	685,123,052.00	**84.60%**
03-Feb-06	1,287,666,744	1,126,838,360.00	**87.51%**
15-May-06	812,416,492	586,531,086.00	**72.20%**
14-Sep-06	884,839,905	779,701,828.00	**88.12%**
27-Nov-06	1,035,876,800	713,540,014.00	**68.88%**
20-Mar-07	884,684,337	740,051,247.00	**83.65%**
25-May-07	1,235,734,023	983,388,269.00	**79.58%**
31-Jul-07	1,763,238,616	1,326,104,330.00	**75.21%**
15-Nov-07	1,257,665,858	1,019,691,622.00	**81.08%**
13-Mar-08	1,458,587,318	1,167,348,044.00	**80.03%**
01-Apr-08	1,183,192,614	977,050,335.00	**82.58%**

SOURCE: SEC FOIA Office, Bloomberg, CSI Data, FinancialContent, MarketWatch and Dow Jones.