NCANS

National Coalition Against Naked Short Selling - Failing to Deliver Securities

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100 F Street, NE
Washington, DC 20549-0609

RE : Amendments to REG SHO, Release No. 34-56213; File No. S7-19-07

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Ladies and Gentlemen:

We are very pleased that the SEC is considering eliminating the market maker exemption - a policy of permitting market makers to keep open delivery failure positions that they intentionally cause to persist beyond T+3.

For the reasons expressed in this comment letter and for the reasons set forth in our September 30, 2006 comment letter on File No. S7-12-06., we recommend that, for the sake of protecting investors, for the formation of capital, for protecting the reputation of securities issuers, and for the sake of protecting the reputation of the U.S. securities markets, that the SEC eliminate the market maker exemption completely.

In addition, we believe that the SEC has written the market maker exemption so narrowly and lacking such key requisite components as to render it confusing and useless - an admission the SEC makes when it says that the market makers have misinterpreted the scope of the exemption. As we analyze the shortcomings of the market maker exemption, it becomes clear that the rule is too badly flawed to be meritorious at any level.

The following are reasons why the SEC must eliminate the market maker exemption:

1. **Market Maker Exemption is Fatally Flawed**

The primary flaw is the SEC's failure to use its exemptive authority to exempt Sections 5 and 12 of the Securities Act of 1933 and Sections 9 and 17a of the Securities Exchange Act of 1934, to permit market makers to effect delivery failures that are intentionally caused to persist beyond T+3.

How can the SEC permit delivery failures to remain open, without allowing them to be created in the first place? It's like permitting thieves the use of goods they steal, despite the fact that stealing is prohibited in the first place.

The SEC knows how to craft all-encompassing rules, as the SEC has previously done a commendable job of crafting all-encompassing and well understood rules. As an example, the SEC has used its authority in a clear and sweeping manner to draft and adopt rule 15c6-1 – "The Settlement Cycle." This rule is easy to interpret, and leaves no gray areas. This modification to the Securities Acts was necessary to permit delivery failures to be intentionally caused and persist up to T+3, but not beyond T+3. It limits in its plain language delivery failure past T+3, de facto allowing failures up until then. If the SEC really wants delivery failures to be intentionally caused and to persist beyond T+3, the SEC must use its authority to formalize such a rule, as it did with 15c6-1. Until the SEC does so, the Securities Acts prohibit such delivery failures from being effected.

Specifically the SEC would have to use its authority to create a rule allowing market makers to ignore Sections 5 and 12 of the Securities Act of 1933 and Sections 9 and 17a of the Securities Exchange Act of 1934, in order to permit effecting delivery failures that are intentionally caused to persist beyond T+3.

As a result of the SEC's failure to pass such a rule and exempt these sections from the Securities Acts, market makers have resorted to interpreting more meaning into the market maker exemption, than what the exemption actually states. <u>They have been equating the close-out exemption in REG SHO, with permission to **effect** delivery failures that can intentionally be caused to persist beyond T+3, even though nothing in REG SHO grants this permission.</u> Nor are there any other SEC rules exempting market makers from compliance with the Securities Acts, and thereby permitting effecting delivery failures past T+3.

Without exempting these provisions past T+3, the market makers (and not just the option market makers), are clearly in violation of these provisions:

Section 5 of the Securities Act of 1933
Section 5 requires that all securities credited to investor accounts be registered. With the exemption in SEC rule 15c6-1, this is after the settlement cycle is complete. So any securities credited to accounts **after T+3** must have a registration statement. It does not matter if these securities are "placeholder" securities, "securities entitlements" or any other type of security, as these are all <u>securities</u> as defined by the Act.

Keeping delivery failures open past T+3 <u>without</u> registering the "placeholder" securities or "securities entitlements" and <u>without</u> crediting the correct securities into accounts, causes deliberate misrepresentations and misinformation that Section 5 prohibits.

These placeholder securities confer a different set of rights to investors, completely different than the rights genuine registered securities confer. For instance, "Securities Entitlements" and other placeholder securities do not have voting rights, rights to dividends, rights to non transferable rights offered by the issuer, and rights to legal recourse – as genuine registered securities do.

Section 9 of the Securities Exchange Act of 1934
When delivery failures persist past T+3, broker-dealers, clearing agents, market makers and depositories obscure the fact that the registered security didn't trade, by creating the **appearance** that the registered security traded. This is done by crediting the trade symbol of the genuine registered security to investors and markets, rather than the "placeholder" security's trade symbol – despite the fact that the registered security never traded with requisite delivery.

We presume this is done because the "placeholder" securities are not registered and therefore do not have a trade symbol of their own. So for the purpose of obfuscating the true nature of what was actually delivered to the buyer (an unregistered "placeholder security" or "security entitlement") the next best thing is used – the symbol of the never delivered, but purchased, genuine security.

This false reporting of completed trades, which actually did not conclude as mandated by the Act, is an intentional deception and merely causes the **appearance** of markets and trades, which is prohibited under Section 9 of the Securities Exchange Act of 1934.

Section 12 of the Securities Act of 1933
Section 5 of the Securities Act of 1933 clearly prohibits the sale of unregistered securities and Section 12 clearly permits recovery of lost capital due to this activity.

By deliberately misinterpreting the market maker exemption and by not complying with Section 5 and Section 12, market makers are therefore exposed to legal liability commensurate with the number of delivery failures that they cause to persist past T+3.

Section 17a of the Securities Exchange Act of 1934
The Congress finds that,

> *The prompt and accurate clearance and settlement of securities transactions, including the transfer of record ownership and the safeguarding of securities and funds related thereto, are necessary for the protection of investors and persons facilitating transactions by and acting on behalf of investors.*

It is difficult to imagine a clearer and less ambiguous direction from Congress. Thus, when delivery failures occur outside T+3, all provisions of 17a are violated.

The comprehensive set of requirements and prohibitions spelled out in 17a provide the clear intent of the U.S. Congress, and still apply to market makers - until the SEC exempts market makers via a formal rule making process.

As such, the current market maker exemption is too narrowly written as it fails to provide necessary exemptions to the Securities Acts.

We recommend that the market maker exemption be eliminated entirely based upon the way it is being interpreted by the market makers, and its lack of compliance with formal rule making that would properly exempt market makers from having to comply with relevant sections of the Acts.

This makes moot the market maker exemption as written and at best makes it confusing, thereby inviting market makers to violate the Securities Acts, without proper authorization

2. Investors are Harmed

Even without the aforementioned structural problems, the market maker exemption would have to be eliminated because it causes harm to investors. This reason alone is sufficient to eliminate it, as the main purpose of the SEC, and especially its rule making, is to protect investors:

Section 36 of the 1934 Act specifically allows the SEC to create exemptions to the 1934 Act, **"*…to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors…*"**

Protecting Investors is the highest priority of the SEC, as stated in the SEC's mission statement.

Apparently the SEC recognizes the harm that equity security investors are subjected to at the hands of option market makers, when those options market makers fail to deliver equity securities (at no cost to them) and then keep unsettled trades open for as long as they wish. NCANS sees this as not only as a predatory and harmful practice, but also a totally unnecessary one. In the derivatives markets, options market makers can make markets, provide liquidity and hedge their options perfectly well without delivery failures in the equity markets.

Liquidity of derivatives and making markets in derivatives cannot be created by harming equity investors, nor based upon delivery failures in equity markets.

Borrow Fees Withheld From Investors
One way investors are harmed is when market makers do not borrow to deliver securities and therefore do not pay borrow fees to securities investors.

When the market maker exemption is eliminated, the increase in borrow fees to market makers shouldn't be exorbitant overall, as most equity securities are not REG SHO threshold securities and have plentiful securities available to borrow at low cost. This means liquidity in put options and other derivatives should not see any significant impact in liquidity or pricing for the lion's share of securities.

It also creates a balanced market for borrowing securities. When demand is high, so too would the borrow fees be, and the fees received by the owners of the securities. As is stands now, only market makers benefit from not having to borrow securities used to hedge – at direct cost and harm to equity investors.

Market Maker Risks and Costs Transferred onto Equity Investors
Delivery failures past T+3 transfers the risk exposure and hedging expense of the derivatives onto the backs of the equity investors, without any benefit to equity investors, thereby harming them by adding the additional risk and cost. This can not be tolerated by investors in equity securities. The options market makers must price in the risk exposure and borrow fees into their market without subsidies from equity securities investors. This profiting at the expense of equity

investors must stop - derivatives liquidity for options speculators cannot be at the expense of equity investors.

The options market makers, in the Susquehanna letter, have stated that they hedge in a "market neutral way." But the market makers are not limiting their liquidity to achieve a put/call balance in any security, so there is no guarantee of hedging neutrality in any particular security. In fact the industry comment letter from the various exchanges states the opposite: *"In our experience, while most options market makers try to achieve a market neutral position by the end of each trading day, they may not be "flat" in the sense of having no long or short positions or an equal number of long and short positions."*. It's precisely in the heavily shorted equity securities and threshold securities that we see more put options than call options written and traded and therefore delivery failures by the option market makers. Equity market neutral hedging can never be assured. As a matter of fact, this aspect can be exploited to manipulate the price of targeted securities downward by buying large numbers of put options in these already heavily shorted securities.

Eliminating the market maker exemption would protect investors by eliminating the capacity to manipulate the price of securities by buying large amounts of cheap put options on the derivatives market in heavily shorted securities. The manipulators know they will make money in this scheme because they are buying the put options ahead of the market maker's short sale of the security. They know the security will be short sold to hedge the put option, regardless of the options market makers' ability to borrow or deliver. In fact they will short the security first and then effect the market maker to do the same in large quantities.

For the protection of equity investors, all risk exposure and hedging expense of options and derivatives need to be paid for by the derivatives markets and not in any way transferred onto the backs of unsuspecting equity investors. One major requisite in achieving this is to eliminate the market maker exemption.

Market Makers not Making Markets

Registered market makers in equity securities are failing to make markets in certain securities and using the market maker exemption to cause delivery failures past T+3 for their own benefit instead. How is it otherwise possible that in securities where there are no options traded, where the only market makers are the ones in the equity security, that these securities wind up on the REG SHO threshold list despite the fact that the price has been dropping?

If the market makers were really making a market in a security, they would be net buyers as investors sell, not net sellers themselves. So why would they naked short sell into a falling market? What purpose does it serve except to make money for their own accounts as the price drops? For market makers and not just options market makers, the exemption serves as an excuse to execute prohibited trades and strategies.

Of course the market makers will say that they are indispensable to "price discovery" – whatever that means. But we contend that investors can decide themselves what price points they want to by and sell at. We believe permitting fails for 3 days is enough to make a market in any security.

To put all investors and market participants on the same page and so that all are treated equally and to stop this abuse, the market maker exemption must be eliminated without exemptions for any market makers.

3. Issuers are Harmed

The market maker exemption harms not only investors directly, but also the issuers. By enabling no-cost creation of unregistered securities to flood the market (failed deliveries past T+3 credited to investor accounts are clearly not delivered, registered securities, and thus are something other than registered securities) via options market maker hedging using the exemption and market makers simply naked short selling for their own accounts, the SEC has enabled market makers to effectively dilute the true market and value of equity securities, harming the issuers for whom their equity securities are their currency.

This diminished access to capital for victimized issuers. This diminished access to capital in turn increases the cost of capital for these issuers, loading a burden on them that they otherwise would not have.

If this trade condition of open fails persists for a long period, investors will shun the security or invest at only ever lower prices because of the diminished price its securities trade at over a long period of time.

4. Formation of Capital is Hindered

When securities of targeted issuers are abandoned by investors due to the effects of delivery failures, it reduces the amount of capital these issuers can put to productive use, in order to create capital in the first place.

This ever-diminishing capital access and formation is fatal to many issuers and in aggregate to the securities markets. The market maker exemption is exactly counter to the purpose and mission of forming capital, as it serves only to enrich the market makers at the expense of everyone else. If the SEC really wants issuers to have as much access to capital as possible, the SEC must eliminate the market maker exemption.

5. Reputation of U.S. Markets is Harmed

The veracity and integrity of a market where certain types of derivative market speculators can impact the value of the underlying asset upon which the derivative is based, as is the case with the current scheme in the US equity markets with the options market maker exemption, is at risk. It is a case of the tail wagging the dog, and is an invitation to predatory market manipulators to target companies, and then manipulate the price of their securities down, by abusing the market maker exemption's capacity to create unlimited delivery failures for hedging purposes. At that point, the market's basic predicate of supply and demand based pricing is violated, and a fair and balanced auction market becomes a killing field for victimized issues and the investors therein. Any time a loophole is structured that will allow a certain class of participants to have an advantage over equity investors, history has shown it will be abused. The market maker exemption is a clear example of that sort of abuse.

Conclusion

The market maker exemption provably harms investors and issuers, hinders the formation of capital, and is fatally flawed as written. It should be eliminated immediately, and any other outcome will continue to harm the interests of investors, and is contrary to investor protection. The SEC is not chartered with favoring market making participant interests over the interests of investors, thus any decision other than immediate elimination of the exemption would be against the charter of the Commission.

Thank you for this opportunity to comment on this vitally important issue.

Regards,

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NCANS