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The International Association of Small Broker-Dealers and Advisers,www.IASBDA.com submits the following comments on the above referenced anti-fraud rule for short sales.The Association believes that it is an inefficient and ineffective use of the Commission's rulemaking power and that it is another use of incrementalism in fighting the long war against naked short selling.Like a nuclear weapon in guerilla warfare,it sounds tough but cannot be used.Nine years have passed since the initial concept release on short sales.It has been 17 years since the problem of naked shorting was identified by a Congressional sub-committee.SHORT-SELLING ACTIVITY IN THE STOCK MARKET: MARKET EFFECTS AND THE NEED FOR REGULATION (PART 1)Committee Reports,102d Congress,House Rept. 102-414,*102 H. Rpt. 414*,DATE**:** December 6, 1991. Contrary to the staff's assertion at the open hearing,this report also specifically detailed complaints about the spread of false rumors in connection with naked short sales.The Association believes that a firm locate(pre-borrow) as defined hereafter in Part II is the only cure for this continuing problem. The Association further believes that the Commission has not adequately considered how this incremental regulation of naked short sales will implode under another 9/11 situation if the markets are kept open.There is nothing to stop opportunistic short sellers from unlimited short selling in a crisis atmosphere. After the fact sanctions will be useless to small companies and small investors caught in a death spiral of opportunistic short selling.As we explain in part II there needs to be a self enforcement mechanism for such a situation to prevent the sale before it occurs.

I) The Proposed Rule is Ineffective and Delays the Implementation of An Effective Firm Locate

We believe the proposed rule is ineffective and inefficient because:

- The Staff acknowledged at the open hearing that they already have the authority to bring such charges.
- The failure to include lenders and/or decrementing in the rule allows a continuing use of fictitious locates which makes scienter impossible to prove.In this regard the enforcement division should have been present at the open meeting to provide its views and answer questions on aiding and abetting and scienter under these circumstances.
- The rule misleads the public by suggesting an aggressive weapon and takes time and resources away from the development of an effective new rule.
- The rule effectively protects the stock loan industry from serious regulatory scrutiny of their locate procedures including especially their failure to decrement the locates they provide.

The rule as proposed very specifically targets short sellers who fail to locate and borrow the securities they sell,but does not target the lenders who have great incentives to provide locates they cannot fulfill.The rule targets the users but not the dealers.The prime brokerage industry provides the hedge fund industry with the borrowed stock necessary to facilitate short sales.But they do not actually have to provide the stock. All they have to do is provide a non-binding promise which promise is extremely valuable as it allows short selling without the cost of a borrow i.e it creates phantom shares.Faux locates are further evidenced by the prevalence of locates for stocks under $5 a share that are not eligible for margin.The Commission needs to ask where these locates come from if the stock cannot be margined and institutional investors do not hold them.As many commenters have noted the creation of phantom shares also occurs in the NSCC stock borrow system.Therefore there is no legitimate reason that the creators of phantom shares should not be specifically subject to these new rules,especially when the staff acknowledged at the open hearing that an aiding and abetting application is unlikely.The release specifically asks whether the proposed rule should provide that a person be liable if it deceives another person about its intention or ability to deliver securities in time for settlement . The obvious answer is why not, especially when the lenders do not decrement and thereby knowingly overlend. The Commission specifically recognized this dilemma in its 2006 proposed amendments to Reg SHO when it asked for comments on whether these lenders should be required to either pre-borrow or decrement their locates.

Should we impose a mandatory "pre-borrow" requirement (i.e., that would prohibit a participant of a registered clearing agency, or any broker-dealer for which it clears transactions, from accepting any short sale order or effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security) for all firms whenever there are extended fails in a threshold security regardless of whether that particular firm has an extended fail position in that security? If so, how should we identify such securities? What criteria should be used to identify an extended fail? Should this alternative apply to all threshold securities? What are the costs and benefits of imposing such a mandatory pre-borrow requirement? What percentage of these pre-borrowed shares would eventually be required for delivery?

Rule 203(b)(1)'s current locate requirement generally prohibits brokers from using the same shares located from the same source for multiple short sales. However, Rule 203(b)(1) does not similarly restrict the sources that provide the locates. We understand that some sources may be providing multiple locates using the same shares to multiple broker-dealers. Thus, should we amend Rule 203(b)(1) to provide for stricter locates? For example, should we require that brokers obtain locates only from sources that agree to, and that the broker reasonably believes will, decrement shares (so that the source may not provide a locate of the same shares to multiple parties)? Would doing so reduce the potential for fails to deliver? Should we consider other amendments to the locate requirement? Would requiring stricter locate requirements reduce liquidity? If so, would the reduction in liquidity affect some types of securities more than others (e.g., hard to borrow securities or securities issued by smaller companies)? Should stricter locate *requirements be implemented only for securities that are hard to borrow (e.g., threshold securities)?*

The Commission was on the right track in asking these questions but two years later it now proposes an anti fraud rule that adds nothing to its arsenal or to answering these questions.The ineffectiveness of the rule also delays the Commission in implementing a truly effective rule because of the waste of resources in rulemaking for authority the staff already has.Taking comments on this rule prevents additional rulemaking on pre - borrows,decrementation,added disclosure and many other remedies for naked short selling.In the long war against naked short selling this is a distraction which cannot be afforded at this time.The Commission should realize that a firm locate/pre-borrow or at least a mandatory decrement of locates is what should be on the table now and they can be easily added to the proposed rule**.**

II) A Firm Locate(Pre-Borrow) Proposal

a) REG SHO CAN BE SIGNIFICANTLY MORE EFFECTIVE WITH PRIVATE ENFORCEMENT OF A FIRM LOCATE ADDED

In its proposal on Reg SHO the commission explained, "FINRA predecessors' rules generally required that members only "locate" stock available for borrowing. For example, NYSE Rule 440C.10 stated that no NYSE member or member organization should "fail to deliver" against a short sale of a security on a national securities exchange until a diligent effort has been made by such member or member organization to borrow the necessary securities to make delivery. An NYSE interpretation to the rule further stated that member organizations effecting short sales for their own account or the accounts of customers must be in a position to complete the transaction. The interpretation stated that no orders to sell short should be accepted or entered unless prior arrangements to borrow the stock have been made or other acceptable assurances that delivery can be made on settlement date.

The comparable NASD Rule 3370 generally provided that no member, or person associated with a member, shall effect a short sale for a customer or for its own account unless the member makes an "affirmative determination" that the member can borrow the securities or otherwise provide for delivery of the securities by settlement date. The affirmative determination must be annotated in writing, evidencing that the member firm will receive delivery of the security from the customer or, if the member firm locates the stock, the identity of the individual and firm contacted who offered assurance that the shares would be delivered or were available for borrowing. This requirement applies regardless of how a short sale order is received, *e.g.*, by the telephone, an electronic transmission, the Internet, or otherwise."

b) CLOSE-OUT AND BUY IN PROVISIONS IN FORMER RULES

"The NASD had also adopted several rules addressing failures to deliver. NASD Rule 3210 prevented a member, or person associated with a member, from selling a security for his own account, or buying a security as a broker for a customer if, with respect to domestic securities, he had a fail to deliver in that security that is 60 days or older. NASD Rule 11830 imposed a mandatory close-out requirement for Nasdaq securities that had a clearing short position of 10,000 shares or more per security and that are equal to at least one-half of one percent of the issue's total shares outstanding. NASD Rule 11830 generally required that a contract involving a short sale in these securities, for the account of a customer or for an NASD member's own account, which

- had not resulted in delivery by the broker-dealer representing the seller within 10 business days after the normal settlement date (currently transaction date + 3 business days),
- must be closed by the broker-dealer representing the seller by purchasing for cash or guaranteed delivery of securities of like kind and quality."

This mandatory close-out requirement did not apply to bona-fide market making transactions and transactions that result in fully hedged or arbitraged positions just as exceptions from the NYSE rule were provided for short sales by specialists, market makers, and odd lot dealers in fulfilling their market responsibilities.

Reg. SHO addressed the close-out requirements by essentially adopting the NASD's approach in creating a threshold list with similar parameters. If the stock was not on this list all that remained for private enforcement was an NSCC requirement that was and remains voluntary. NSCC Rules, Article VII, subsection J. The regulators have imposed mandatory buy-ins for stocks not settling thru NSCC. See NYSE information memo 05-100.providing for buyer- initiated buy-ins. Fn 2 and 3. See also the discussion in 55 Brooklyn Law Review at p.1280. There is therefore no private enforcement requirement unless a stock is on the threshold list thereby inviting opportunistic short sellers to avoid the costs of borrowing.

c) THE LOCATE REQUIREMENT SHOULD BE A FIRM CONTRACT

The current locate requirement remains unchanged from the previous requirement. A short seller needs only locate the stock among the various lenders without a contractual obligation to borrow (pre-borrow). But it is assumed on the Street, and the regulators have not disputed that, a short seller only has to locate once and if that fails there is no continuing duty to find another locate. Therefore to an opportunistic short seller, a failed locate is better than a filled locate because a failed locate avoids all borrow costs. This suggests that there is a market for locates that are never intended to be filled and that those who provide them may be rewarded in other ways for example thru trading commissions.As previously noted the SEC approached this problem in its 2007 Reg. SHO amendments when it asked for comments on whether the prime brokers should be required to decrement after giving a locate. Nothing has been said about decrementing since this request two years ago. Therefore there is no penalty for failing to locate,no duty to decrement and borrowing costs are avoided. This is a no lose proposition for short sellers in a declining market.

Numerous comments on the evils of naked short selling have suggested that a firm locate is the ultimate solution including former SEC chairman Harvey Pitt. See Comments at http://stopphantomshortselling.org/UpcomingEvents.html. However, few of these comments have defined what that means. Most believe that in its simplest form it means if you don't borrow the stock a penalty should be imposed. In the past many have suggested a universal mandatory buy-in requirement, where the buyers or selling brokers will purchase the stock in the open market if not received on time. But those who are experienced with doing so know that buy-ins risk litigation over the correct price and collection of the loss incurred. Furthermore it is most likely that such buy-ins will result in another naked short by a market maker. When a locate results in a failure to provide the stock, there is no risk to the short seller unless he is bought in by the buyer. A buy- in at a price above the short sale is an automatic loss to the short seller, but only when the buyer is able to collect thru some form of litigation thereby hurting its street reputation. This is why the industry prefers flexibility in the system allowing for the fail to work itself out. Other suggestions have included the State of Utah's attempt to impose fines for failure to disclose a fail and a current Canadian proposal to notify the regulators of all fails.

d) MANDATORY BUY- INS EQUAL PRIVATE ENFORCEMENT AND ARE MORE EFFECTIVE THAN REGULATORY ACTION

A defining element not often discussed in the naked shorting debate is that the regulatory structure is ill prepared to enforce these concepts and that the system needs a private enforcement mechanism.. As professor Jim Angel of Georgetown has noted there needs to be a certain penalty for failing to deliver otherwise opportunistic fails are inevitable. Regulators have been justly criticized for imposing traffic ticket sanctions, but how many cases can be brought at the expense of other violations. The best idea is one where the parties themselves enforce the borrow requirement. But there is often confusion over who is the culprit in a fail to deliver. The hedge funds will blame the prime brokers who are not required to decrement their inventory when providing a locate.. But the prime brokers will say that like the airplane industry they have to overbook because some borrows will not be needed. Many would say that a contractual pre-borrow is necessary where the lender is contractually bound to deliver. Indeed the industry has argued in the past to be allowed to pre-borrow. But the industry now argues that such a pre-borrow will tie up unnecessary amounts of securities thereby exaggerating the problem. A government response to these arguments places the government in an unending umpire role.

e) A FIRM BUY-IN EQUALS A FIRM LOCATE

Both lender and borrower should be responsible for all failed locates with very liquid stocks excepted. Their individual share of the problem should be worked out amongst themselves. Neither the buyer nor the regulators should have to be involved. In other words the transaction should be settled by normal contractual relationships with the most negligent party incurring most of the cost. This may require an arbitration to determine such costs In this case the goal of such an arbitration is delivery of the stock which means either party has to buy in the open market or find it somewhere else. Therefore it's the lender and short seller who bear the burden of the buy in as determined by the arbitrator. We believe that the threat of an arbitration verdict will change the incentive for locating the stock. In other words faced by a loss on the buy-in one of the responsible parties will have an incentive to clean up the fail. A failure by the bd borrower to initiate arbitration would be considered a violation of SRO rules. While this may seem cumbersome, it will for that very reason be a deterrent to fails. There has never been a mandatory buy -in rule for all fails which is the basis of a firm locate rule. Currently Reg. SHO is very weak on the buy-in related to the threshold list because the penalty is only a prohibition on further shorting that security. However as noted above a firm buy-in for the bd borrower would put the burden where it belongs and force the seller and broker borrower to remedy the fail. A broker that relies on the short seller to borrow would be <u>similarly mandated and any difference would be arbitrated between the two.</u> An escape clause could allow the lender faced with a buy-in to apply to FINRA for an exception based upon mitigating circumstances thereby providing notice to FINRA as to why loans fail and allowing FINRA itself to guide the parties.

f) A LIMITED PILOT HAS NO DOWNSIDE

There is a legitimate argument that these requirements will reduce liquidity in the stock loan market. The real question is how much liquidity. The only answer is to test such reduction by using a pilot beginning with the less liquid stocks as was done with the removal of the tick test. We believe that the stock loan community will adjust by decrementing their supply and by penalizing borrowers who fail to borrow. We think that short sellers and lenders would reach an accommodation in regards to penalties for borrows not completed with FINRA able to excuse justifiable fails. The Pilot should involve the least liquid stocks while leaving the threshold list in place.The CNS system of NSCC should be pre-empted to accommodate such Pilot.

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