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Ms. Nancy M. Morris, Secretary
Securities and Exchange Commission
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Dear Ms. Morris:

Here are my comments on the proposed changes to Regulation SHO, the "Naked" Short Selling Anti-Fraud Rule. The proposal adds a new rule, 10b -21 which clarifies that deceiving a broker or a dealer or a purchaser about the ability or intent to deliver stock on the normal settlement date is an illegal practice.

It is important to fix the problem of extended settlement failures, but this rule won't do it.

It is extremely important that the Commission take steps to prevent the extreme and protracted settlement failures that have led to so many complaints. Although such failures may affect only a small fraction of stocks at any one time, the ability to fail provides a tool for stock price manipulation. Protracted failures have afflicted large well known companies such as NYSE-Euronext, Netflix, Martha Stewart Omnimedia, and Overstock.com. This raises questions about the fairness of our capital markets and the effectiveness of SEC oversight.

Failing to deliver a security on time forces a buyer to make, in effect, an involuntary stock loan to the seller. This tramples upon one of the basic rights of a property owner, the ability to exclude others from use of the property. Many investors are rightly upset at the notion that they may be forced to lend their newly purchased shares without their consent to a short seller seeking to bring down the price of their shares. The buyer may also be deprived of voting rights and may also suffer from the differing tax treatment of substitute dividends. Other shareholders of the company that operate stock lending programs are also harmed because the use of involuntarily loaned shares may cut demand for legitimate borrowing.

Settlement failures threaten market quality for ETFs.

Even the most casual glance at the recent Regulation SHO Threshold Lists reveals that over 100 ETFs and ETNs are on the Threshold List. This indicates that it may be hard to short many of the affected ETFs. As the ability to short an ETF is essential to facilitating the arbitrage necessary to maintain proper pricing for the ETF, large settlement failures here threaten the integrity of the ETF marketplace. A quick glance at the failure data recently released by the SEC quickly reveals dozens of cases in which more than a billion dollars worth of specific ETFs failed for multiple days. The SEC needs to find out why this is happening and quickly disclose the reasons. Since it is easy to create ETF shares *in theory*, there should be no reason to fail. Presumably there is some practical impediment to timely delivery in this market and the SEC should explore ways to fix this problem. Perhaps the typical creation unit size for an ETF is too big, or perhaps there are burdensome delays or expenses in the creation process. This inefficiency in the marketplace needs to be understood and then fixed.

This Band-Aid™ won't do much to fix the problem.

The Commission has stated repeatedly that it is investigating charges of naked short selling and engaging in enforcement activities. Merely stating that an already illegal activity is illegal won't change much. It might put a little more fear of the SEC into law-abiding compliance people, but it won't do much to change the behavior of the sleazoids who abuse the flexibility in our settlement system to create the large and protracted failures that are embarrassing our capital markets. Even worse, this rule as proposed could impose huge compliance costs on investors.

The unclear wording of the proposed rule could ensnare innocent investors.

Although the proposing release states that scienter would be required for a violation, a plain reading of the language of the proposed rule does not make this clear. Indeed, a plain reading could be stretched to a criminalization of almost all failures to deliver, however unintentional. The proposed § 240.10b-21 states:

> It shall constitute a "manipulative or deceptive device or contrivance" as used in section 10(b) of this Act for any person to submit an order to sell a security if such person deceives a broker or dealer, a participant of a registered clearing agency, or a purchaser about its

intention or ability to deliver the security on the date delivery is due, and such person fails to deliver the security on or before the date delivery is due.

Suppose that a long seller places a sell order electronically and exchanges no further communication with the broker/dealer. One could assert – as the proposing release does -- that the mere placing of a sell order is a communication that implies that the customer intends and has the ability to deliver the security on or before the date delivery is due. Alas, there is a back-office glitch in the seller's organization and the trade fails to settle on the regular settlement date. The broker/dealer/purchaser has clearly been misled about the ability of the seller's organization to deliver the security, but have they been deceived under this rule? This is not clear in the language of the rule.

Suppose that an investor places a short sale through a retail broker. The retail broker locates the stock to borrow on the trade date in another customer's margin account. However, on date T+2, the customer pays off the debit balance in the margin account, making the shares fully paid and thus difficult to lend. The broker is unable or unwilling to find other shares to deliver and fails to deliver the shares on the settlement date of T+3. Has the customer violated this provision? Has the broker? The customer was clearly unable to deliver the shares. Even though the proposing release seems to vindicate the customer, it is not clear from the language of the rule.

The wording should be revised to make it clear in plain English that intent is required by adding the word "intentionally" before "deceives."

The rule language should also specifically address those who are exempt from the location rules.

Equity market makers are exempt from the location rules, and rightly so. Because they turn over their inventory so frequently, it makes no sense for them to locate shares when they have no intention of sitting on a short position long enough to actually need to borrow the shares. Yet, because of the inefficiencies in the stock loan market they are sometimes unable to find shares to borrow on settlement date at any price. This is especially true for the smaller stocks that need the liquidity providing activities of market makers.

The proposing release seeks to interpret the proposed rule, but it does so in a confusing way. On page 12 it states bluntly that market makers selling for their own accounts are covered by the rule. Yet on page 14 the proposing release contradicts itself issue by stating that market makers engaging in "bona fide" market making are exempt because they are exempt from the locate rule.

It is highly unlikely that many years from now a FINRA or SEC inspector will bother to go back to the proposing release for this level of interpretation. Instead, they are likely to use their understanding of the plain language in the text. If the SEC means what it says in the proposing release, then this should be stated clearly in the text of the rule.

The rule will effectively require "hard borrowing" prior to trading.

Given the way compliance works in this industry, this rule will have the practical effect of requiring "hard borrowing" before every short sale for law abiding firms. Because of the risk of penalties for innocent fails, compliance officers will demand that shares actually be borrowed (not just located) before every sale order, long or short, adding more complexity and expense to the trading environment. Alas, the rogue firms that push the envelope of the rules will not bother and will continue to evade the intent of the rules. Thus, this rule is a classic example of a complex rule (like the uptick rule of old) that imposes lots of costs on law abiding people who are not abusing the system while doing nothing to prevent the abuses that led to the rule in the first place.

If the intent of the SEC is to require hard locates or preborrowing, then it should go through the appropriate rule making procedures to do so.

There are some practical problems with a hard locate or pre-borrow rule. Such a rule would have to be crafted very carefully to make sure that it achieves it purposes in an efficient manner. Many orders are not executed, and thus the borrowing would have occurred for nothing. Even if a trade is executed, many things can occur between trade date and settlement date that may cause a legitimate locate to not become an actual need to borrow. The seller may cover the short position later on the trade date, and thus eliminate the need to deliver any shares. The seller's broker may find shares to borrow in-house and thus not need to go to the external market. Thus, the shares would have been borrowed for no reason. There are better ways to achieve the objective of the proposed rule – reducing settlement failures – than requiring the paperwork hassled involved in borrowing before placing short sell orders. These better ways are discussed below.

Settlement failures will persist as long as there are economic incentives to fail.

Protracted settlement failures exist because market participants sometimes have an economic incentive to fail to deliver for long periods of time. In normal circumstances, sellers (even short sellers) have a strong incentive to deliver shares on the normal settlement date: They don't get paid until they deliver the shares. If they delay, they lose the ability to earn interest on the proceeds. For the vast majority of stocks, the cost of borrowing shares in the stock loan market is less than interest that can be earned, so there is still a very strong incentive to deliver on time.

Because of this natural financial incentive, there is little need for draconian rules to require settlement on the standard date – most of the time.

However, for some stocks that are extremely hard to borrow, the situation reverses. When the cost of borrowing the stock is higher than the interest that could be earned on the proceeds of the sale, short sellers have an incentive to put off borrowing the shares they need to deliver as long as possible. By failing to deliver on time, they effectively force the buyers into making involuntary stock loans. The buyers are thus deprived of potential stock loan revenue as well as voting rights. The buyers may also have tax problems with substitute dividend payments that are taxed at different rates than normal dividends.

One could ask why more buyers don't exercise their ability to buy in the shares that have not been delivered on time. Fortunately, the elegant design of our settlement system comes to the rescue. Because buyers receive their shares on approximately a first-come first-served basis, the pain of a failure to deliver is passed from one buyer to the next. In most instances, the buyer receives the shares in a few days. The trouble and expense of executing a buy-in, which is a labor intensive manual process, may exceed the stock loan revenue for those few days. Thus, each buyer loses only a small amount, but in aggregate buyers are losing approximately $100 million per year in stock loan revenue. [1] This is similar to the specialist interpositioning case in which investors lost only a few pennies on each share traded but the total damages resulted in hundreds of millions of dollars. [2]

Fixing the economic incentives will solve the problem.

As long as the economic incentive to fail exists, rational players will attempt to find and exploit loopholes in the rules. The experience of Regulation SHO demonstrates this. Three years after the creation of the Threshold List and vigorous SEC enforcement, we still see several hundred stocks on the list and many of them have been on the list for over 100 days.

Knife-edge rules create opportunities for manipulation.

As short sales now constitute approximately 25% of our equity volumes, a reliable and efficient stock lending market is absolutely essential to the proper functioning of our markets. If equity and option market makers cannot find or borrow shares at reasonable prices, they become unable to provide liquidity to the markets. This causes an increase in volatility and a decrease in depth in our markets, driving up transactions costs to investors.

Rules that absolutely positively demand settlement on a particular day, whether it is T+3 or T+30 or T+300 create fertile room for manipulators and game players. When the markets sense that the deadline date is at hand, a short squeeze may push the price far above its true intrinsic value. Such short squeezes could harm even investors who legitimately located and borrowed the shares. During periods of unusual market events, such as in the post 9/11 environment or in the current credit crunch, imposing draconian delivery rules may exacerbate market volatility.

There are two basic ways to reduce the economic incentives to fail to deliver: Reduce the cost of borrowing shares, and raise the costs of settlement failures.

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[1] The details of this calculation are in my previous comment letter www.sec.gov/comments/s7-19-07/s71907-117.pdf .

[2] For example, see http://www.sec.gov/news/press/2004-42.htm.

Look for ways to reduce borrowing costs.

The stock lending market is a fragmented OTC market much like the old OTC equity market before the rise of NASDAQ. This fragmentation is driven by the problem of assessing counterparty risk. Arrangements need to be made in advance long before a particular stock loan is made. The cost of monitoring counterparties places a natural limit on the number of counterparties any particular firm is willing to deal with. Thus, many brokerage firms have arrangements in place with only a handful of counterparties. When stocks are hard to borrow, they often pass through multiple hands on their way between the ultimate borrowers and lenders because of the fragmentation of the system. The SEC should examine the stock loan market and look with favor upon innovations that can improve the efficiency of the market.

Modernize Rule 15c3-3 to make it easier to lend fully paid shares .

The Customer Protection Rule (15c3-3) provides some well meaning safeguards to prevent the loss of customer securities. However, the rules protecting fully paid and excess margin securities make it practically impossible to lend such shares because of the steps involved. These rules can be streamlined to facilitate the lending of such shares while still maintaining appropriate safeguards as well as consumer choice. The current system for protecting shares that have been margined works extremely well and can provide a template of the safeguards needed to protect fully paid and excess margin shares. Among other things, Rule 15c3-3 requires the broker to:

- Provide the lending customer a schedule of the securities borrowed at the time of borrowing.
- Transfer collateral or an irrevocable letter of credit to the lending customer.

These restrictions do not apply to the lending of margined shares and are not really needed for the protection of fully paid shares. They do, however, make it impractical to borrow retail quantities of shares from retail accounts.

In particular, modernized safeguards might work as follows: Brokerage firms would be permitted to modify their customer account agreements to permit the lending of fully paid and excess margin securities, although customers must have the right to prevent the lending of any or all of their securities without penalty. The account disclosures would clearly state that permitting such lending may result in loss of voting rights if the shares are actually on loan on the record date for a corporate election, and that substitute dividend payments might be taxed at higher rates than normal dividends. Such disclosures would be a big improvement over the current black box warnings labels on margin accounts, which do not reveal the risks of lost voting rights or painful tax treatment of substitute dividends.

Customer protection through collateral or a letter of credit would be provided at the firm level, not at the individual account level as it is now.

Streamlining procedures for lending fully paid shares from customer accounts would increase the number of shares available for stock loan, and thus reduce the cost of stock borrowing. This in turn would reduce the incentives for short sellers to fail to deliver stocks that are expensive to borrow.

Increase the cost of failure with appropriate late fees.

As long as those who fail to deliver on time get a free ride, they will continue to seek ways to fail when it is in their economic self interest. By charging late fees, there will be more of an incentive to deliver on time. The economically appropriate fee would be the cost of borrowing the stock in the market, assuming that the stock loan market was operating efficiently and free of manipulation. Although this number might be hard to determine given the current market structure, instituting a late delivery fee -- instead of a draconian buy-in rule -- would be a step forward in reducing incentives to fail. Such a fee could be credited to the accounts of those who are waiting to receive, or it could be used by the clearing entity to cover overall expenses and reduce charges in other areas.

Another alternative: Give buyers the option to bust a failed trade.

Another approach to reducing settlement failures would be to give the buyers who have not received their shares within a reasonable time the option to bust their trades. For example, a buyer who does not receive the shares within 3 days of the normal settlement date (e.g. on T+6) could demand that purchase trade be busted. This would create a very large incentive for sellers to deliver shares when the stock has gone down. As the buyer would only bust the trade if the shares have declined in value, it is effectively a put option for the buyer. The value of the put option thus compensates the buyer for the trouble imposed by the failure of the seller to deliver the shares on time.

This put option back to the seller would also help undo any damage done by so-called “naked” short selling. Suppose a naked short seller sells a large quantity of shares which are not delivered, and thus depresses the price. By busting the failed trade, the naked short seller is deprived of the gain caused by the naked shorting.

Recall that NSCC nets all buy and sell orders and then allocates incoming shares on approximately a first-come first served basis. This means that the shares delivered by one seller may actually be delivered to a buyer who purchased earlier from a different seller who failed to deliver. Thus, most buyers will receive their shares in a few days even when there are settlement failures. Only in extreme cases will a buyer fail to receive the shares long enough to trigger the ability to bust the trade. However, it is just these extreme cases that need to be prevented.

Let the SROs figure out the details.

Clearing entities such as NSCC are licensed by the Commission as SROs. I have enormous respect for the capabilities of DTCC and its affiliates NSCC and DTC. They are experts in this area and can probably do a pretty good job of crafting the details. With all due respect to the SEC, I believe that DTCC can do a better job than the SEC of working out a solution to this problem in an economically

rational manner. The Commission should let the SROs do their job as SROs of figuring out the details of the rules. All they need is some gentle prodding from the Commission. The SEC could fix the whole problem with a rule requiring the SROs to have rules for the prompt settlement of securities trades. As I mentioned in a previous comment letter, possible language might be:

> *Each clearing agency shall establish, maintain, and enforce written rules that are reasonably designed to:*
>
> *(1) Require its members to deliver securities on the customary settlement date;*
>
> *(2) Provide appropriate economic penalties to members failing to deliver a security on the customary settlement date; and*
>
> *(3) Publicly disseminate on its web site daily information regarding the number of shares that are failed to deliver for each security.*

These economic penalties could be late fees, or the ability to bust a failed trade. The Commission has demonstrated through the numerous iterations of Regulation SHO that it does not understand the nature of the problem. It should therefore delegate the solution to the industry so that this can be solved in an intelligent and cost effective manner.

Respectfully submitted,

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References

Previous comment letters by James Angel, Georgetown University, on Regulation SHO:

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