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Secretary
Securities and Exchange Commission
100 F St. NW
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Rule-comments@sec.gov

Release No. 34-58107; File No. S7-19-07
Regulation SHO

Dear Secretary:

Here are my comments on the proposal to eliminate the option market maker's exemption from the closeout requirements in Regulation SHO. With over 400 stocks on the Threshold List, and more than 50 on the list for over 100 days, there is a clear problem with extended settlement failures. The existence of over 100 ETFs on the list is also extremely disturbing, as short selling is essential for keeping ETF prices in line with the ETF constituents. I have personally experienced trouble shorting several ETFs.

The data recently released by the SEC in the extending release, along with the original proposing release, make it clear that the option market maker exemption is a large contributor to the persistent and extended settlement failures. Accordingly, eliminating the option market maker exemption will go a long way towards clearing up the persistent settlement failures that are an embarrassment to our capital markets. This should be accomplished as quickly as possible.

Why shouldn't option market makers have to pay to borrow shares like the rest of us?

When the cost to borrow shares in the stock lending market is higher than the interest on the proceeds, options market makers have an economic incentive to fail to deliver the shares as long as they can. And they do. Since there is no firm requirement for them to actually deliver shares by a particular date, settlement can be postponed indefinitely.

In most instances, the problem is not that of locating shares to borrow, it is a problem of not being willing to pay the market price. Although the stock lending market is filled with cost-increasing inefficiencies, shares can usually be found – for a price. I see no reason why options market makers should not have to pay the same market prices as the rest of us do to borrow stock. They can easily build the higher cost of borrowing hard-to-borrow shares into their pricing models. Options market makers are excellent risk managers, and they can also manage the jump risk associated with unanticipated changes in borrowing costs just as they manage the jump risk in underlying equity prices.

The exemption permits options market makers to force buyers into making involuntary stock loans without proper compensation.

When a seller fails to deliver shares, it forces the failing-to-receive buyer into making an involuntary stock loan without proper compensation. In my previous comment letters I have estimated potential losses at over $100 million per year.

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.

However, the elegant design of the U.S. settlement system spreads out the pain widely so that no one investor is inconvenienced for very long. Because shares are (to a very rough approximation) passed out on a first-come first served basis, a failing to receive investor will usually receive the shares within a few days. Even though the losses in the aggregate may be large, it is often not worth the time and expense for the buyer to force a buy-in.

If the stock loan market is that bad, then let's fix the stock loan market.

Proponents of retaining the exemption may claim that the stock lending market functions so poorly that sometimes they cannot borrow stock on reasonable or even any terms. If that is the case, then public policy should focus on fixing the many inefficiencies in the stock lending market. Again I reference my previous comment letters for suggestions here.

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. Getting rid of the option market maker exemption will help, but the financial incentives will still exist. Putting in reasonable late fees will improve the situation. There are late payment fees for many financial obligations as well as overdue library books, so why not late fees for late delivery of stock?

Similarly, giving those who are failing to receive the ability to bust a trade if delivery does not occur within three business days of the normal settlement date would also provide a powerful incentive to deliver on time. Since most accidental fails are settled within three days, this would not penalize such short-term inadvertent failures. Such a potential penalty would serve as a large disincentive to manipulative naked short selling, as it would deprive a naked short seller of the profit from such a manipulative strategy.

Let the SROs figure out the details.

As I have mentioned in my previous comment letters, 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. The SEC should rely upon their expertise and delegate to them the further details of fixing the problem.

Respectfully submitted,

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References

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

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