Rule Number S7-120-06: Comments on Proposed Amendments to Regulation SHO
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I am Robert J. Shapiro, chairman of Sonecon, LLC, an economic analysis and advisory firm in Washington, D.C. From 1998 to 2001, I was Under Secretary of Commerce for Economic Affairs. Prior to that, I was Vice President and co-founder of the Progressive Policy Institute and Vice President of the Progressive Foundation, and continue to be a Senior Fellow of the Progressive Policy Institute. I also served as principal economic advisor to Governor William J. Clinton in his 1991-1992 presidential campaign, senior economic advisor to Vice President Albert Gore, Jr. in his presidential campaign, Legislative Director and Economic Counsel for Senator Daniel Patrick Moynihan, and Associate Editor of *U.S. News & World Report*. I have been a fellow of Harvard University, the National Bureau of Economic Research, and the Brookings Institution. I hold a Ph.D. and M.A. from Harvard University, a M.Sc. from the London School of Economics and Political Science, and an A.B. from the University of Chicago.

I currently advise the law firms of O'Quinn, Laminack and Pirtle and Christian, Smith and Jewell on economic issues related to failures to deliver, including matters raised in the proposed amendments to Regulation SHO. The views expressed here are my own and do not necessarily represent the views of any person or firm that I advise.

In these comments, I will provide new data and analysis supporting the Security Exchange Commission's (SEC or "Commission") judgment that Regulation SHO has failed to substantially resolve the problem of large-scale, strategic failures-to-deliver ("fails"). As the Commission notes, these fails affect significant numbers of stocks and, in many cases, harm their markets. I will urge the Commission, first, to create and enforce total transparency on this matter for both investors and corporate managements by directing the Depository Trust and Clearing Corporation (DTCC) to release historical data on large-scale fails in individual stocks, so that independent analysts at the SEC and elsewhere can analyze and assess the extent to which these fails have damaged particular public companies. To ensure the efficient operations of financial markets in the future and relieve the DTCC's serious conflict of interest in this area, I will urge the Commission to direct the DTCC in the future to release data on large-scale fails in individual stocks on a daily basis, as the exchanges do today with respect to the trading volume and short sales in individual stocks.

I also will urge the Commission, as it has proposed, to promptly phase-out the current grandfather provisions of Regulation SHO, which enable investors or broker-dealers to maintain large-scale fails in individual stocks for extended periods, potentially damaging the market for those stocks. These fails reduce the efficiency of U.S. financial markets, in many cases seriously damage individual stocks and, in some such cases, provide a means for stock manipulation and other criminal activities which have been widely documented. Large-scale, extended fails represent a threat to the basic integrity of our markets and consequently warrant careful and decisive regulation.

I strongly urge the Commission to re-establish the basic principle that, just as one cannot sell long what ones does not own, one cannot sell short what one does not borrow. Under this principle, the Commission should require short sellers to actually borrow shares before selling them short, or at a minimum to affirmatively locate them before selling them short, in all instances and not merely those in which the stock already carries substantial, extended fails meriting "threshold security" status. The Commission also should eliminate the existing perverse economic incentives for short sellers to fail to deliver: In cases in which a seller receives payment for shares that have not been delivered, the short seller should be liable for a charge that at least equals the borrowing costs avoided by his failing to borrow and deliver the shares; and in cases of large-scale, extended fails, the charge should reflect the profits earned by the naked short sale. These new requirements would not affect those who document that their delay in delivering shares arose from paperwork or other innocent administrative problems or from legitimate market making activities.

With the increasingly significant role of short sales in U.S. equity markets, effective measures to ensure the integrity of short sales has become a matter of genuine urgency. I recently analyzed data covering trading on the New York Stock Exchange from February 1, 2006 to July 31, 2006 and found that more than one in every four shares traded every day are sold short.[1] The data show:

- Short sales account for 25.5 percent of all NYSE shares traded on a daily basis, or an average of 297 million shares per day out of an average of 1,163 million total shares traded every day.

- The lower a company's share price, the greater the proportion of short sales in all trading in its shares: Among NYSE companies selling for $20 or less per share, short sales account for about 28 percent of all shares traded, compared to about 24 percent of all shares traded in companies selling for $40 or more per share.

- The lower a company's market capitalization, the greater the proportion of short sales in trading in its shares: Among NYSE stocks with market caps of $2 billion or less, short sales account for nearly 28 percent of shares traded, compared to less than 24 percent of shares traded in stocks with market caps of more than $10 billion.

The complete analysis and database are available for the Commission's review on request.

[1] The data covered trades transacted through the Super Designated Order Turnaround System (SDOT) for six months The SDOT system captures more than 85 percent of all orders executed on the NYSE, from, a sample of 1,947 NYSE-listed operating companies that excluded closed-end funds and exchange traded funds.

I also will strongly urge the Commission to not only eliminate the two grandfather provisions in Regulation SHO, but also appreciably shorten the periods in which large-scale extended fails are tolerated before being subject to mandatory buy-ins. The proposed, additional grace period of 35 days for failures currently grandfathered creates a special tolerance for extended fails established in the past. It has no economic justification, especially as the final regulation will be issued weeks or months before its date of implementation. I will recommend that currently grandfathered fails be subject to mandatory buy-in five days after implementation of the amendment. I will also urge the Commission to shorten the grace period before mandatory buy-ins for non-grandfathered fails in threshold securities, a total of T+11, to reduce the likelihood of large-scale fails doing serious damage to the market for stocks so affected. Additional time could be provided for investors who can document that a delay in delivering shares arose from normal paperwork problems or legitimate market making operations. I also will urge the Commission to consider applying mandatory buy-ins to cases of failed deliveries whether or not they occur on the scale required for a stock to be designated a threshold security. This approach is used in Germany, Austria and Singapore, and the Commission could apply it initially in a pilot program limited, for example, to stocks designated as threshold securities in the previous year. .

Finally, I will urge the Commission to investigate the extent to which substantial and persistent fails to deliver may occur outside the DTCC's normal clearance and settlement system, through "*ex clearing*" arrangements between private financial institutions. The potential harm to the efficiency of the markets and to individual stocks of large-scale, extended fails should be the same, whether they are transacted through the normal DTCC clearance process or through *ex clearing* arrangements. The critical difference is that fails occurring through *ex clearing* may elude the requirements of Regulation SHO, both in its current form and under the proposed amendments. Should the Commission's investigation establish substantial activity in fails and naked short sales through *ex clearing* arrangements, I strongly recommend additional regulation to ensure that all transactions are subject to the same scrutiny and investor protections.

Before addressing each of these matters in more detail, I want to commend the Commission for its clear recognition and cogent analysis of the inadequacies of Regulation SHO in resolving the problem of large-scale, extended failures-to-deliver. I also have analyzed the effectiveness of Regulation SHO and found similarly disturbing results. I examined the threshold security lists issued by the New York Stock Exchange (NYSE) and NASDAQ-NM over the period January 7, 2005 to April 3, 2006. The analysis of the companies listed over that period found:

- Regulation SHO has not prevented brokers from continuing to transact sales without delivery in the stocks of large numbers of companies. Over the 15-month period, a total of 500 NYSE companies and 516 NASDAQ-NM companies were designated threshold securities.

- Over the 15-month period, Regulation SHO also has not prevented brokers from failing to deliver large number of shares in the same company on

multiple occasions: 175 of the 500 NYSE threshold securities, or 35 percent, were listed as threshold stocks multiple times, as were 224 of 516 NASDAQ-NM threshold securities, or 43.4 percent.

- Regulation SHO's buy-in requirements failed to resolve the extended fails in 25 percent to almost 30 percent of all threshold securities: 147 of the 500 NYSE threshold securities or 29.4 percent remained on the list for more than 18 days (the 13-day cut-off, plus five days following), as did 130 of 516 NASDAQ-NM threshold securities, or 25.2 percent.

- Regulation SHO does not prevent large-scale fails in a particular stock from persisting for very extended periods:

    - Over the 15 months examined here, 66 of 500 NYSE threshold securities, or 13.2 percent, were listed for at least 30 consecutive trading days (6 weeks); 36 were listed for at least 40 consecutive trading days (8 weeks) ; and 16 were listed for at least 60 consecutive trading days (12 weeks).

    - Of the 516 NASDAQ-NM threshold securities examined here, 80 or 15.5 percent, were listed for at least 30 consecutive trading days; 54 were listed for at least 40 consecutive trading days, and 32 were listed for at least 60 consecutive trading days.

The complete analysis and database are available for the Commission's review on request.

These findings reinforce data reported by the Commission in the narrative accompanying the proposed amendments, documenting the failure of Regulation SHO to drastically reduce the aggregate number of fails, the average age or duration of those fails, the number of stocks with large-scale, extended fails, and the average number and duration of those large-scale, extended fails. The SEC analysis found that in the 17 months following implementation of Regulation SHO (January 1, 2005 to May 31, 2006), compared to the eight months preceding its implementation (April 1, 2004 to December 31, 2004),[2]

- The average number of securities with at least 10,000 fails declined by only 6.5 percent, while the number of those securities with fails also exceeding 0.5 percent of their outstanding shares declined by 38.2 percent;

- The average total number of fails for all companies with at least 10,000 fails declined by only 15.3 percent;

[2] Release No. 34-54154, File No. S7-12-06, footnote 18; Memorandum from the Office of Economic Analysis, August 21, 2006, www.sec.gov/spotlight/failstodeliver082106.pdf..

- The average duration of a fail position declined by only 13.4 percent.

A close examination of the SEC data behind these findings reveals that the most recent results are even more disturbing. While the average monthly number of threshold securities was 38.2 percent lower for January 2005 through May 2006, compared to April 2004 to December 2004, the SEC monthly data provided in the analysis (Memorandum from the Office of Economic Analysis, August 21, 2006, Table 2) show that the entire decline occurred from June 2005 to January 2006. Since February 2006, the average monthly number of threshold securities has increased significantly and now matches the numbers meeting the criteria in the pre-Regulation SHO period.

In addition, roughly one-third of the modest, 15.3 percent improvement in the average daily number of fails for securities with at least 10,000 fails reflects the 6.5 percent decline in the number of securities meeting that criterion, not the decline in average fails per-security. Furthermore, DTCC data for January 2004 through March 2006 released under the Freedom of Information Act[3] show that the decline in the total number of fails for securities with at least 10,000 total fails occurred entirely from January 2005 to November 2005. Since that time, the total number of these fails has risen sharply again.

While month-to-month data on the average duration of fails for securities with at least 10,000 fails are not provided, data on the average duration of fails for threshold securities are provided. These data also show that the average duration of fails in threshold securities has shown no improvement from January 2005 to May 2006.

The most encouraging data reported by the Commission staff purports to show that among threshold securities, average daily fails declined by 52.4 percent. Once again, however, this result came from comparing average monthly data for the entire period January 2005 to May 2006, with data for April 2004 to December 2004. The Commission has released data showing that since December 2005, the average monthly fails for all companies with at least 10,000 fails rose sharply. The SEC now should provide a month-by-month breakdown – or better yet, a daily breakdown – of fails for threshold securities, so one can determine whether the number of average fails per threshold security has risen or fallen in recent months, as the average monthly number of threshold securities and the average monthly number of fails for companies with 10,000 fails have both increased.

Finally, without data showing the distribution of those fails by company, month by month and day by day, we cannot say whether any decline in the total fails of the threshold securities represents a meaningful reduction in the incidence of the large-scale extended fails that can harm the market for individual stocks.

The following comments on the proposed amendments to Regulation SHO are intended to address the shortcomings established by the above analyses. Regulation SHO should be revised to (1) sharply reduce the number of instances in which, in the SEC's

[3] See "Games Short Sellers Play," Bob Drummond, *Bloomberg Markets*, September 2006, p. 126.

words, “the level of fails to deliver for the particular stock is so substantial that it might harm the market for a security;”[4] and (2) eliminate instances in which such potentially damaging large fails persist for an extended period.

Before addressing these issues directly, permit me to clarify the context in one important respect. While the proposed amendments note that fails “may result from either short sales or long sales of stock,” the issues raised by instances in which large-scale, extended fails “might harm the market” for a stock involve almost exclusively fails arising from short sales, or “naked short sales.” There are cases in which fails arise from long sales based on “human or mechanical errors or processing delays … (that) result from transferring securities in physical certificate,” as well as cases in which market makers properly “sell short thinly-traded, illiquid stock in response to customer demand … (and) encounter difficulty in obtaining securities when the time for delivery arrives.”[5] However, it would be disingenuous to suggest, imply or conclude that such cases explain more than a very small minority of fails and an even smaller fraction of threshold securities. Errors and delays involving physical certificates are necessarily rare, because as the DTCC reports, 97 percent of shares are held in electronic form, compared to less than 3 percent held in paper form by investors or their brokers. On the rare occasions when errors occur and delays arise from problems securing these paper certificates, it is very unlikely that more than a handful involve both the large numbers of shares and extended periods of failure required to be designated a threshold security. Similarly, while market makers charged with maintaining the market in an illiquid stock will sell shares short without borrowing them, such market-making leads to fails that can usually be resolved on the same day or very shortly thereafter. Only on very rare occasions would market makers be forced to maintain fails for weeks or months at a stretch in the proper conduct of market making.

The extent to which large-scale extended fails involve naked short sales -- not inadvertent problems with paper certificates or the legitimate activities of market markers – is important to the integrity of U.S. financial markets. There is a long history of large-scale naked shorts being used to manipulate stock prices and defraud companies and their investors. The most widespread instances of such fraud occurred in the death-spiral financing scams of the latter 1990s and the first years of this century, when large-scale naked shorts were used to damage or destroy hundreds of public companies. I reviewed 357 instances of death-spiral financings and found that within one year of entering into such financing, these companies lost on average 82 percent of their stock market capitalization. Adjusted for changes in the overall market over the same periods, the companies targeted by death-spiral financiers and then subjected to large-scale naked short sales lost on average 68 percent of their market value in the first year, for total losses of $28.2 billion in the 357 cases I examined. (The database from which these results are derived is available for the Commission’s review.) The use of naked short sales for purposes of manipulation or other violations did not end with death-spiral finance. Recently, the SEC and other law enforcement or regulatory authorities have

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[4] SEC, 17 CFR Part 242, RIN 3235-Aj57, “Introduction.”
[5] *Ibid,* fn. 4.

documented numerous additional cases in which naked short sales have been used to facilitate insider trading or fraudulent billings to investors.

There are no data more critical to evaluating the degree to which large-scale extended naked shorts continue to damage the fair and honest operations of U.S. financial markets, and "harm the market" for individual securities, then the number of outstanding fails for each stock. While the Commission has released data on the total number of fails for listed and OTC threshold securities – roughly 500 million shares on any given day, though greater in recent months -- there are no public data on their distribution.

The DTCC holds the data which can definitively establish the percentage and numbers of fails for every individual stock arising from short sales and long sales, and from legitimate market making operations and problems with paper certificates. The DTCC has all those data, especially for threshold securities, but will not release them to the affected companies or anyone else, asserting that their release would reveal proprietary trading strategies. In my judgment, this claim is entirely disingenuous. Release of those data would not reveal trading strategies using legitimate short sales, since data on outstanding short interest and daily short sales by security issue are already publicly available. The additional data would only disclose the extent to which such trading strategies rely on *naked* short sales. Those using naked short sales as part of their trading strategies have no special claim to secrecy about the total numbers of naked shorts held in each stock, especially since such naked short sales violate the rules of the exchanges and the Commission and, when used for manipulative purposes, potentially criminal statutes as well.

The DTCC's refusal to release these data and render the matter transparent materially damages the efficiency of U.S. financial markets and impedes the Commission's capacity to protect American investors. Without those data, investors, company managements and regulators cannot know the extent to which fails have harmed the market for the individual stocks so affected. The DTCC's failure to release those data, therefore, distorts the pricing information on which investors and managements rely to evaluate past performance and future prospects, impairing the efficiency of the capital markets. The SEC first publicly established the overall dimensions of fails when the DTCC was directed to provide access to the data for an independent, visiting economist at the SEC, Dr. Leslie Boni. The Commission should now clarify the issue of the distribution of fails by directing the DTCC to release the relevant data for independent analysis and subsequent publication by economists at either the SEC or an appropriate academic institution. Without these data, investors, managements and regulators cannot know or judge the extent to which concerns about naked short sales being used to manipulate the prices of certain stocks are justified, or the particular instances of such manipulation.

The DTCC's monopoly control over those data and its secrecy about them raise other very serious concerns. The DTCC is chartered as a trust company with a fiduciary responsibility to ensure that every trade is fairly and properly cleared and settled. It describes its responsibilities in this area in unambiguous terms:

> "It is the job of [the DTCC and NSCC] to provide an efficient and safe way for the buyer and seller to exchange securities and money, thus 'clearing and settling' the transactions. … NSCC steps into the middle of a trade, becomes a contra-party to both firms and guarantees completion of the transaction … during this time period [three business days] to ensure sellers are paid and buyers receive their securities in a manner that reduces risk, cost and post-trade uncertainties."[6]

However, the DTCC is also privately-owned by brokers-dealers, clearing houses, stock exchanges and other private financial institutions, many of which have financial interests in transactions that are not fairly and properly cleared and settled, but involve extended, large-scales fails to deliver. This presents a classic conflict of interest. An entity with a powerful conflict of interest should not be permitted to withhold information from the companies affected, investors and regulators about the dimensions and details of the transactions which occasion that conflict. Therefore, I strongly urge the Commission to direct the DTCC to issue data on outstanding fails by security issue on a daily basis, in the same way that the NYSE today issues daily data on short sales by security issue.

In my judgment, data which are already publicly available indicate that the concerns about large-scale naked short sales noted above are both warranted and serious. I analyzed the trading volume and outstanding short interest of all NYSE and NASDAQ-NM stocks listed as threshold securities on three days chosen at random: 159 stocks listed on February 15, 2005; 143 stocks listed on March 22, 2005; and 125 stocks listed on April 26, 2005. While only the DTCC has access to the data that would establish for certain whether the total fails in the threshold securities listed on those days were generally distributed broadly and randomly across all of them or substantially concentrated in a small number of them, the public data on trading volume and short interest may provide clues. It matters, once again, because if those fails are highly concentrated, it is much more likely that they arose from naked short sales that "harm the market" for those stocks by artificially driving down their prices.

The proposition here is that in a given set of securities with a given number of outstanding fails, the largest numbers of fails are likely to occur in those securities that account for the largest shares of the trading volume and the largest shares of their outstanding short interest. If this proposition is reasonable, the distribution of the given number of fails on any day will bear some relationship to the trading volume and short interest of each of those securities, relative to the entire sets of them. Our analysis found that trading volume and short interest in threshold securities are highly concentrated in a small number of them: The data show that 10.5 percent of threshold securities can account for 73.8 percent of the trading volume and 74.7 percent of the short interest in all of those securities.

- Among the 159 NYSE and NASDAQ stocks listed as threshold securities on February 15, 2005, 15 or 9.4 percent accounted for 77.2 percent of the

[6] See www.dtcc.com.

preceding month's trading in all of that day's threshold securities and for 77.1 percent of the total short interest for all those threshold securities in that month.

- Among the 143 NYSE and NASDAQ threshold securities of March 22, 2005, 15 or 10.5 percent accounted for 59.7 percent of the total trading volume for all of that's days threshold securities in the preceding month, and for 63.1 percent of the total short interest for all those threshold securities in that month.

- Among the 125 NYSE and NASDAQ threshold securities of April 26, 2005, 15 or 12 percent accounted for 84.4 percent of the preceding month's total trading volume for all of that day's threshold securities, and for 83.8 percent of the total short interest for all of those threshold securities in that month.

The data documenting these findings are available to the Commission on request.

These data suggest that extended fails are in all likelihood very highly concentrated. The Commission has found that fails which exceed the threshold level "may harm the market for the security." Earlier, we presented data showing that Regulation SHO has failed to prevent fails at the threshold level from persisting in individual stocks for extended periods. The additional evidence that the fails of stocks on the threshold lists may be highly concentrated at any given time in some 10 to 20 stocks, at levels far above the threshold level of harm to the market for those stocks, suggests that very large-scale extended fails – principally massive, naked short sales – do seriously damage certain companies and could potentially threaten public confidence in the financial markets. This evidence is clearly consistent with the Commission's view, stated in its commentary to the proposed amendments, that "…large and persistent fails to deliver…can be indicative of manipulative naked short selling, which could be used as a tool to drive down a company's stock price. The perception of such manipulative conduct also may undermine the confidence of investors."[7]

The Commission's proposals to amend Regulation SHO are an important step to reduce these threats. However, to achieve the Commission's stated goals, these amendments should be strengthened significantly. The basic principle that should be applied is the economic essence of any contract: One cannot sell and receive payment for what one does not have the right to sell. In long sales, one should not be permitted to profit from selling what one does not own and deliver; and in short sales, one should not be permitted to profit from selling what one has not borrowed and delivered.

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[7] *Ibid.*, II, B. The concerns do not alter the importance of the legitimate use of short sales in promoting the efficiency and stability of financial markets. Properly executed short sales alert investors to other investors' judgments that a firm may be over-valued and, as part of normal market making activity, can provide liquidity and offset temporary imbalances in the supply and demand for particular stocks.

Based on this principle, broker dealers and clearing houses should be required in all instances to locate and possess the shares involved in every sale. To ensure the investing public that the trading process is transparent and honest – and that they can depend on receiving what they pay for, when they pay for it – in every trade involving a short sale, the seller should be required by regulation to actually borrow shares before selling them short, or at a minimum affirmatively locate them before selling them short. When those shares are not delivered within three days of the transaction (T+3), the broker dealer or clearing house should be required to document that the delay involves securing the paper certificates or normal market making activity. Anything less could ultimately damage investor confidence in U.S. financial markets.

Under this basic principle, a short seller who fails to deliver the shares he has sold and been paid for should not be permitted to profit from what in other contexts would be called a form of economic fraud, unless he can document that the delay involves problems with paper certificates or legitimate market making operations. Allowing short sellers to neglect to deliver for a substantial period without bearing any economic cost for doing so has created a strong incentive to naked short sell, since the short seller benefits from failing to deliver by saving the cost of borrowing the shares. This advantage, in turn increases his potential profit (or reduces his potential losses). In Dr. Boni's phrase, the absence of any cost for failing to deliver creates an incentive for "strategic" fails on a large scale. The Commission can and should put an end to this "strategy." At a minimum, short sellers should be financially responsible for the costs of borrowing shares *whether they fail to deliver them or not.* When an investor sells short and fails to deliver the shares by T+3, he should be required to pay the borrowing charge from T+1 to the actual day of delivery to the buyer, who has paid for shares he has not received. On the buyer's side, this fee would constitute a form of interest on the payment he made for shares that he had not received; on the seller's side, the fee would reduce the current economic incentive to go naked in short selling.

In some cases, the improper benefits to a short seller of failing to borrow and deliver shares that he has sold and for which he has been paid, are much greater. For example, companies whose shares are held largely by their founders or in accounts that are not permitted to lend their shares may have relatively few shares available for borrowing. In such cases, the entire transaction may depend on the improper activity of naked short selling. The only way to eliminate a perverse incentive to undertake naked short sales in such cases is to eliminate the naked short seller's prospect of financial gain. In all cases of extended, large-scale fails – for example, fails of 10,000 shares or more which persist for 10 days or more (T+10) -- in which the seller cannot document that the failure involves problems with paper certificates or legitimate market making operations, the profits from the naked short sale should be remitted to the buyer, as payment for failing to receive what he has paid for.

This sanction would be unnecessary if the Commission would apply a mandatory buy-in within a short period of time to all instances of fails in which documentation of paperwork delays or legitimate market making is not provided. There is no basis in economic or finance theory to justify an extended period in which a seller has received

payment for a financial asset but does not deliver it, unless the buyer agrees explicitly to those terms. Some will claim that a strict rule for prompt, mandatory buy-ins for all fails would be burdensome, but that burden consists simply in having to deliver what one has sold and been paid for. Moreover, other countries with major financial markets have successfully adopted this approach. In Germany, investors are required to arrange the loan of shares they intend to short before they can actually sell the shares short; and if a short seller nonetheless fails to deliver the shares within two trading days of the sale (T+2), the buyer can undertake a "forced execution" by purchasing the security in the open market and recovering the cost from the short seller. Similarly, in Austria, a buyer who does not receive the shares sold to him by a short seller can execute a forced-buy-in within one day of the settlement date (T+3+1); and in Singapore, shares sold short must be delivered on the same day or face a mandatory buy-in (T+1).

If the Commission determines to maintain the current distinction between all fails in principle and cases of substantial and extended fails (threshold securities), I urge it to consider three modifications to its proposed amendments to Regulation SHO.

First, as proposed earlier for all cases of fails not associated with documented paperwork problems or legitimate market making, in every case in which a seller has failed to deliver shares of a threshold security without proper justification, he should be financially liable to the buyer for a fee reflecting the borrowing costs he avoided by failing to deliver what he had sold and been paid for. Only in this way can the Commission address the perverse and economically-powerful incentive to fail to deliver which Dr. Boni analyzed as "strategic" fails.

Second, in these cases of large-scale and persistent fails—threshold securities under Regulation SHO – the naked seller should be subject to a mandatory buy-in with, as the Commission proposes, no exceptions for "grandfathered" fails, and after a much briefer period than the Commission has proposed. The current grandfather provisions exempt from mandatory buy-in fails to deliver of two distinct kinds: Fails to deliver which existed prior to the implementation of Regulation SHO ("grandfather-1"); and fails to deliver which accumulate prior to its designation as a threshold security, especially in the five-day period in which a security's fails must initially exceed the threshold level before it is so designated formally under Regulation SHO ("grandfather-2"). My review of NYSE and NASDAQ-NM securities designated as threshold securities from January 7, 2005 to April 3, 2006 establishes that both forms of grandfathering contribute to the persistence of large-scale, extended fails, and that large-scale extended fails continue to be created with alarming frequency.

- Of 500 NYSE stocks designated threshold securities over this period, 73 or 14.6 percent were listed on the first day (grandfather-1). Among 147 NYSE stocks that remained on the threshold security lists for more 18 days, indicating substantial grandfathered fails, 26 or 17.7 percent were on the first list of January 7, 2005 (grandfather-1). The remaining 121 NYSE stocks that persisted as threshold securities past 18 days reflected

grandfathered fails accumulated subsequent to the initial list (grandfather-2).

- Of 516 NASDAQ-NM stocks designated threshold securities over this period, 57 or 11 percent were listed on the first day (grandfather-1). Among 130 NASDAQ-NM stocks that remained on the threshold security lists for more than 18 days, indicating substantial grandfathered fails, 23 or 17.7 percent were on the January 7, 2005 list (grandfather-1). The persistent threshold status of the remaining 107 NASDAQ-NM stocks, or 82.3 percent of all cases of grandfathered fails, reflected fails accumulated after Regulation SHO was first implemented (grandfather-2).

Again, the data documenting these findings are available to the Commission on request.

The fact that more than 82 percent of all NYSE and NASDAQ threshold securities with grandfathered fails involve stocks that were not designated threshold securities on the first day's lists confirms that the use of large-scale, extended fails persists and is not merely or even substantially a legacy from the pre-Regulation SHO period.

In eliminating both grandfather provisions, the Commission has argued that "allowing flexibility for some failures" is necessary to ensure that market makers will continue to provide liquidity for securities faced with a high probability of mandatory close out, which "may lead to wider bid-ask spreads or less depth." Flexibility for some failures is also deemed necessary to "deter the likelihood of manipulative short squeezes," because "manipulators would be less able to require counterparties to purchase at above-market value." To provide this flexibility, the Commission has proposed that any previously-grandfathered fail that is on the threshold list on the effective date of the amendment must be closed out within 35 trading days.

I urge the Commission to sharply reduce this 35-trading-day grace period. The Commission's public proposals have already informed the market that all current threshold securities and all stocks so designated between now and the Commission's final determinations on these amendments "face a high probability of mandatory close out." Introducing a new 35-day grace period – seven trading weeks -- on top of the five trading days during which the stock earned its eligibility for threshold status, plus however many weeks the grandfathered fails have been protected from mandatory buy-in on the threshold list, would create a special tolerance for or even deference to large-scale, extended fails established in the past. I strongly urge the Commission to dissociate itself from any imputation of special forbearance for persistent activities that clearly violate SEC rules followed by everyone else, negate the basic principles of fair exchange and, in the Commission's phrase, "can be indicative of manipulative naked short selling, which could be used as a tool to drive down a company's stock price."

I can find no economic justification for providing a special grace period for fails currently protected under the grandfather provisions. Since the final regulation will be issued weeks or months before its date of implementation, providing ample notice to

every holder of outstanding fails, I urge the Commission to apply the mandatory buy-in for all existing, grandfathered fails in threshold securities effective no later than 5 days after the day of implementation. In a period in which fails have been used repeatedly in illegal activities, a five-day additional phase-in will put all investors and financial institutions on notice that the Commission no longer countenances such behavior.

I further urge the Commission to shorten the period during which large-scale fails are tolerated. Under the current rules, a mandatory buy-in applies only to sellers who already know that a stock has substantial fails (i.e., is a threshold security) and occurs only after 16 days of failing to deliver shares sold and paid for (T+3+13), or more than three trading weeks. With the elimination of the grandfather provisions, some investors will have 21 days – longer than a trading month – during which they will not have to deliver shares they've sold and been paid for: T+3 (normal delivery) + 5 (qualifying period for threshold status) + 13 (grace period before mandatory buy-in). Other investors who sell but fail to deliver stocks that already have been designated threshold securities will have 16 days, or more than three trading weeks, before they'll be forced to come up with the shares: T+3 (normal delivery) +13 (grace period before mandatory buy-in).

I am concerned that an approach which permits large-scale fails to persist for three to four weeks will allow considerable stock manipulation to continue to occur. In some case in which naked short sellers try to either drive down a stock's price or attract sufficient legitimate short sellers to put additional downward pressure on the price, the process takes several weeks or even months to produce the (illicit) profit sought by the naked short seller. However, in other cases, especially those in which naked short sellers target small public companies, the manipulation can successfully drive down the firm's stock price in two-to-three weeks, seriously damaging its long-term prospects, and end by the close of the third week.

The only justification offered for the current 13-day grace period is innocent delays in delivering shares. Therefore, all cases in which investors or brokers can affirmatively document that the delay in delivery involves securing paper certificates, similar administrative problems or normal market making activity should be exempt from the mandatory buy-in. In all other cases, I urge the Commission to further preclude stock manipulation by shortening the current grace period. For those whose fails occur before a stock is designated a threshold security, the grace period after that designation should be three days, giving them more than two weeks to come up with the shares that they've already sold and been paid for (T+3+5+3 = T+11). Those who fail to deliver shares of a stock already designated a threshold security could have eight days before mandatory buy-in, providing them the same overall grace period (T+3+8 = T+11).

At a minimum, the Commission should provide both classes of investors who fail to deliver the shares they've sold and been paid for the same number of days before mandatory buy-ins. If the Commission retains the current 13-day period before mandatory buy-in, then the total grace period should be capped at 16 days (T+3+13). Those who fail to deliver a stock that was not yet designated a threshold security when the fail occurred would be subject to mandatory buy-in eight days after its designation as

a threshold security, or 16 days after the initial transaction (T+3+5+8 = T+16). Those who fail to deliver shares they've sold in companies already designated threshold securities would be subject to the mandatory buy-in 13 days after the formal fail (T+3+13 = T+16). Again, those who can document that the delay arises from problems with paper certificates, similar administrative issues, or normal market making activity would be exempt from this schedule.

Again, I urge the Commission to uphold the basic principle that those who sell shares and receive payment must deliver them promptly, by considering steps to also reduce fails in stocks that are not designated threshold securities. Requiring that such investors pay the buyer a fee equal to the borrowing costs which they've avoided by failing to deliver would substantially reduce "strategic" fails of both short and long duration. In addition, the Commission should examine an approach more like those currently followed in Germany, Austria or Singapore, which apply mandatory buy-ins to all cases of failed deliveries, whether they occur on the large scale predicated by threshold securities or on a much smaller scale. The Commission could apply this new approach on an experimental basis as a pilot program. For example, fails in any stock that has appeared on a threshold list within the preceding 12 months could be subject to a mandatory buy-in at T+6– a grace period much more generous than those currently provided in Germany, Austria or Singapore – unless the seller can appropriately document legitimate reasons for the delay in delivery. This approach would allow the Commission to establish the costs and benefits of this simplified, deliver-or-else approach. It also would provide the additional benefit of ensuring that no stock designated a threshold security once could reappear on the list for at least a year, preventing naked short sellers from repeatedly targeting a company with successive rounds of large-scale extended fails.

I would like to address two final points: the significance of prospective short squeezes; and the question of "ex clearing" transactions. The DTCC and others have suggested that the release of data on the number or level of fails for each threshold security would produce market volatility–i.e., short squeezes--presumably on the hypothesis that stocks known to carry large numbers of fails would attract speculative buyers whose purchases could drive up the price and so force naked short sellers to either increase their margin or cover their trades, which in turn might further drive up the price. This may occur, or it may not. Many of the critics of strict regulation of short sales insist that when short sellers pile on and a stock's price falls sharply, it simply reflects the underlying value of the stock recognized first by the short sellers. Where this explanation holds, there will be little danger of short squeezes. Where it doesn't apply and naked shorts have artificially driven down the price of the shares, a squeeze directed at those who have failed to deliver the shares they've sold short should be welcome economically, as the market's way of disciplining investors who sell and receive payment for what they do not own, borrow or deliver. More generally, whenever a major distortion takes hold of a market or a piece of it, steps to eliminate or change the factors that produce the distortion inevitably involve costs. Most of those costs will fall to those involved in the distortion, which is appropriate. Over time, large-scale naked shorts have adversely affected many hundreds of companies—perhaps more—and will continue to do so in the

future until the Commission takes strong action. However, the evidence suggests that at any given time, large-scale naked short sales are concentrated in perhaps 50 to 100 companies, so there are no genuine grounds for concern that steps to finally address this problem could entail any market-wide costs.

Finally, I urge the Commission to investigate the extent to which failures to deliver, especially naked short sales, occur through "*ex clearing*" arrangements outside the purview of the DTCC clearance and settlement system. In January 2004, the Commission stated,

> There are a few exceptions to the general rule that the exchanges report all of their transactions to a clearing agency. For example, some exchanges have rules that allow their members to clear and settle transactions outside of the regular clearing system (so-called "*ex-clearing*" transactions). As their name indicates, such trades are not reported to a clearing agency. [8]

In June 2004, the Commission put in place new procedures to track these transactions:

> Under the procedure … adopted today, NASD is required to tabulate aggregate sales volume based on its own trade reporting systems rather than by obtaining clearing data. … While the Commission believes that clearing data is the most accurate record of covered sales when it is available … [m]any internalized trades in equity securities, for example, are never reported to NSCC. Furthermore, the OTC market includes a large number of electronic communication networks ("ECNs") that might not provide NSCC with a trade-by-trade record of their activity. [9]

There are numerous documented cases in which a stock's short interest has exceeded its public float. In fact, in 2004, the Commission also wrote that "at times, the amount of fails to deliver may be greater than the total public float."[10] Some of the explanation for these anomalies may lie in *ex clearing* arrangements. Moreover, since the effectiveness of the Commission's proposed reforms for large-scale fails depends on elements of the formal clearing process, it is imperative that it also ensure that its reforms apply equally to failures to deliver which occur through *ex clearing* arrangements. Otherwise, naked short sellers intent on either escaping borrowing costs or manipulation will be able to thwart the Commission's purview and authority by shifting their operations to *ex clearing* channels.

Concern about the improper use of short sales is as old as the SEC itself. In proposing Regulation SHO, the Commission wrote that "Congress, in 1934, directed the Commission to 'purge the market' of short selling abuses, and in response, the Commission adopted restrictions that have remained essentially unchanged for over 60

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[8] Proposed Rule: Collection Practices Under Section 31 of the Exchange Act. Release No. 49104. January 20, 2004.
[9] Collection Practices Under Section 31 of the Securities Exchange Act, Release No. 49928. June 28, 2004.
[10] *Ibid*., Section II.A.

years."[11] Regulation SHO was the first attempt to reduce short selling abuses; these amendments are the second. When the number of uncovered short sales in a stock reaches a substantial portion of its outstanding shares – or even, as the Commission has noted, exceed its public float – the explanation is usually a concerted and illegal effort by short sellers to flood the marketplace with a kind of phantom share in order to artificially drive down the stock's price and increase the value of their shorts. Massive naked short sales destroy the integrity of the market for the firms so targeted and create a direct transfer of wealth from existing shareholders to illegal short sellers. And the firms typically targeted for such manipulation are generally smaller, younger public firms – the type of company that has generated much of the technological and organizational innovation that has contributed so much to the increases in investment and productivity of recent years.

The Commission has the opportunity to virtually eliminate the threat of failures to deliver for individual companies and the market as whole, by applying a pre-borrow rule for short sales, ending the grandfather provisions, eliminating the economic benefits of failing to deliver, shortening the grace period leading to a mandatory buy-in for sellers who do not deliver what they've sold and been paid for, and applying these rules to all sales whether they are processed through the DTCC or by *ex clearing* arrangements. These changes would eliminate fraud in this area, reestablish the integrity of the clearance and settlement process, and ensure continuing investor confidence in our markets.

[11] Securities and Exchange Commission, "Proposed Rule: Short Sales," 17 CFR 240 and 242, release No. 34-48709, File No. S7-23-03, RIN 3235-AJ00, October 28, 2003.