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Ms. Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F St. NW
Washington, DC 20549-9303

July 18, 2006

File No. S7-12-06: Regulation SHO, elimination of grandfather and options market maker exceptions

Dear Ms. Morris:

Here are my comments on the proposed changes to Regulation SHO. In summary:

- Eliminating the grandfather exception is a good idea.
- Eliminating the option market maker exception for delivery of threshold securities is a good idea.
- These improvements won't eliminate the problem.
- The Commission should seek to improve the stock lending market.
- The Commission should tighten up the delivery rules for non-threshold securities.
- There is a need for better transparency with respect to settlement failures.
- The Commission should examine whether Rule 200(e) makes any sense.

Preliminary remarks

Legitimate short selling is an essential part of our modern capital markets. Short selling now represents about 25% of the equity trading volume on our exchanges. Short selling permits liquidity providers such as market makers to provide liquidity. Short selling makes possible efficient markets in derivatives and structured products such as options and ETFs. Short selling also improves the ability of markets to reflect all available information in a security's price by incorporating negative as well as positive information. Short sellers are our first line of defense against manipulators who would hype worthless securities. Short sellers also help to prevent losses to investors by preventing overpriced securities from becoming even more overpriced.

Our securities clearance and settlement system runs quite efficiently most of the time. As sometimes there are quite legitimate reasons for an investor to fail to deliver a security, the system provides some limited flexibility in settlement by giving a grace period to investors who do not deliver securities on the scheduled settlement date.

Yet there is a widespread perception that this grace period can be abused to manipulate prices through so-called naked short selling, as witnessed by the thousands of investor comments to this and other SEC proposals on short selling.

Blanket assertions by the SEC that it is enforcing our laws do little to encourage investor confidence. Past enforcement lapses have shaken the public's confidence in the ability of the SEC to fulfill its enforcement duties. The inability or the unwillingness of the SEC to crack down on the millions of blatant securities laws violations that show up daily in our email is further damaging the reputation of the Commission. These fraudulent spams are leading many average citizens to view our financial markets in the same light cheap V1@gra hawkers portraying intimate experiences with those lusty low-cut mortgage brokers. This is causing lasting damage to the reputation of our financial markets with long-term consequences for all market participants.

The SEC must take stronger action to restore its reputation and protect the reputation of our capital markets. The proposed changes are good as far as they go, but further action is needed to prevent settlement failures. The SEC should also explore ways of improving the stock lending market.

Eliminating the grandfather exception totally is a good idea.

The grandfather exception creates a particularly perverse incentive for massive failures. In particular, if a stock looks like it may become expensive to borrow, then the shorts have an incentive to fail in large enough quantities to push the stock onto the threshold list and grandfather the fails. Thus exempt from the mandatory buy-ins, they can avoid having to pay to legitimately borrow the stock

The lack of any final deadline at all for the grandfathered fails also makes it easy for those holding grandfathered fail positions to delay delivery indefinitely.

One reason for the grandfather rule is to avoid the market disruption that could occur if there were forced purchases of large numbers of shares. However, this disruption could be prevented by permitting some flexibility in the execution of buy-in trades. For example, the required buy-ins could be limited to 10% of the average daily volume in the stock in any particular day. An alternative would be that the buy-ins should be executed in a manner to consistent with avoiding disruptions to a fair and orderly market.

Providing 35 additional days to buy in the securities just extends the period of settlement failures and provides additional incentives to fail in massive quantities before the stock goes on the threshold list. Indeed, given that some hard-to-borrow stocks may cost 50%

per year to rent, 35 free days would be quite an inducement to keep failing. Given that there will be plenty of advance warning of when the new rules go into effect, there is no need for an additional 35 days.

Eliminating the option market maker exception for delivery of threshold securities is a good idea.

The ability to efficiently sell short is essential for the proper functioning of the options markets. Options market makers need to be able to sell short in order to hedge their positions. If they cannot hedge, then they cannot provide the liquidity needed to make the market function efficiently. Since options may last for months and sometimes years, option market makers need the ability to hedge for months and sometimes years. Furthermore, disruptions in the stock lending market may make it difficult for an options market maker to continue an existing hedge.

It thus makes sense to be cognizant of the special circumstances of the options market makers. The real solution, of course, is to fix the stock lending market.

Alas, exempting market makers from the delivery requirements for threshold securities makes has apparently led some of them to do a simple calculation. They can fail for free and basically pay nothing, or they can pay through the nose to rent the hard-to-borrow securities in the stock lending market. They fail to deliver because it is cheaper than borrowing the shares.

Because of the apparent abuses of this exemption, I think that it is a good idea to get rid of it. Option market makers can, like everyone else, go into the stock lending market and pay (sometimes through the nose) to borrow the shares. Thirteen days should be plenty of time to arrange a borrow. The market makers, of course, will build borrowing costs into their models and thus the price of the options, as they should. Although borrowing costs may fluctuate, options traders are pretty good at dealing with volatile prices.

If the Commission decides to keep the exemption, it should be aware that the wording of the proposed changes to the regulation with respect to market makers is unworkable. Options market makers usually hedge their positions on a portfolio basis. A single options market maker may have numerous long and short positions at different strike prices and different expiration dates in various classes of options on a single equity. Typically, their software calculates the "Greeks" with the different partial derivatives of the entire position with respect to the underlying security price, volatility, time, and so forth. The firm then hedges its entire position. Thus, the firm may be long or short the underlying stock, and it does not make sense to try to assign that particular position to any one of the hundreds of outstanding options on that particular stock. Furthermore, the firm will modify its hedge position frequently as its positions change, as time changes, and as the underlying asset changes.

These improvements won't eliminate the problem.

Although Regulation SHO has made some improvement in the fail-to-deliver problem, and these improvements will make a little more improvement, they deal only with securities whose settlement failures have been so extreme that they wind up on the threshold list. The improvements here do not deal with the underlying problems that result in stocks ending up on the threshold list in the first place.

The SEC staff memo from the Office of Economic Analysis points out that 6,223 stocks "graduated" from the threshold list during the first 18 months of regulation SHO. Since there were a daily average of 424.31 stocks on the list in January 2005, this implies that almost 6,000 stocks had settlement failures severe enough to wind up on the list AFTER the implementation of SHO. During the first 18 months of the threshold list, approximately 20% of NYSE-listed and NASDAQ-listed stocks have wound up on the list at one time or another. This indicates that settlement problems affect a wide swath of respectable companies, not just a few little penny stocks. At this rate, sooner or later every major company will experience settlement problems severe enough to wind up on the list.

The implication is clear: The Commission should also take steps to prevent settlement failures in the first place. It can do this by improving the stock lending market, and by tightening up delivery rules.

The Commission should seek to improve the stock lending market.

Because short selling is so important to the efficient functioning of our capital markets, it is essential that the stock lending market function properly. Indeed, it appears that many of the failures to deliver occur because it is just too difficult or expensive to borrow stocks. Improving the functioning of the stock lending market will reduce the economic incentive to fail to deliver.

There are many steps that the Commission can take to improve the functioning of the stock lending market. For example, the Commission can relax rules that impede the efficient functioning of the market. The customer protection rule, Rule 15c3-3, is a good example of well-meaning rule with unanticipated negative effects. The provisions of 15c3-3 make is so difficult (but not impossible) to lend shares out of cash accounts or excess margin accounts that it become impractical for most accounts. Yet, shares are routinely lent out of margin accounts with extraordinarily few problems. This is one area where the SEC does a really good job protecting the public. It is possible to reduce the bureaucratic barriers to lending out of cash accounts while still protecting the customer's securities.

The Commission should also explore increasing transparency in the stock lending market. Stock trades are immediately reported to the consolidated tape. The Commission should also consider whether to require the dissemination of stock lending transactions should also be disseminated.

<u>The Commission should tighten up the delivery rules for non-threshold securities.</u>

One of the reasons for settlement failures stems from the flexibility in our settlement system. While some flexibility is needed to deal with inadvertent failures, the abuses of this flexibility have lead to the problem we have with extensive and pervasive settlement failures. The Commission should tighten up its rules for the settlement of trades in non-threshold as well as threshold securities.

In particular, there appear to be no rules that explicitly require all trades to be settled or bought in. For example, Rule 15c3-3, paragraph m, would seem to require that brokers buy-in failed positions after 10 business days:

> "(m) *Completion of sell orders on behalf of customers.* If a broker or dealer executes a sell order of a customer (other than an order to execute a sale of securities which the seller does not own) and if for any reason whatever the broker or dealer has not obtained possession of the securities from the customer within 10 business days after the settlement date, the broker or dealer shall immediately thereafter close the transaction with the customer by purchasing securities of like kind and quantity"

However, because of the "other than an order to execute a sale of securities which the seller does not own" exemption, this rule does NOT apply to short sales. Extending this rule to short sales (and actually enforcing it) would go a long way to eliminating the problem.

<u>There is a need for better transparency with respect to settlement failures.</u>

It is very difficult for individual investors to determine whether the noise over the failures to deliver in a particular stock is a serious problem or just an attempt to divert attention from underlying problems in the firm. Improved transparency will allow individual investors to see for themselves whether there is a problem. The current threshold list merely alerts investors that failures are above the threshold. By how much the failures have exceeded the threshold is still a closely kept state secret, which provides fertile grounds for conspiracy mongering.

I recommend releasing daily data with respect to the total number of failures-to-deliver, their sizes, and their ages on a stock by stock basis. This will allow investors to see for themselves whether there is a problem.

There is an obvious concern whether such information will reveal proprietary trading strategies or otherwise promote manipulative games. In order to reduce the value of the data to manipulators, there could be a time lag of approximately one week.

Furthermore, the issuers of securities should also get better information regarding settlement failures in their stocks. The Commission should work with the issuer community to figure out which information is useful and how it should be transmitted to issuers.

Examine whether Rule 200(e) makes any sense.

Finally, the proposal seeks to change the index used for various restrictions under Rule 200(e). Although the proposed change appears minor, the Commission should examine whether Rule 200(e) makes any sense at all. This rule, like 80a, is an artifact of the idea that we should throw sand in the gears of index arbitrage at certain times. This notion grew out of the crash of October 19, 1987 when the physical systems of the market were unable to keep up with trading volume. While the volume of computer-driven index arbitrage trades may have been problematic back in the bad old days of manual markets, today's fast markets are well suited to processing these trades in an efficient manner. Indeed, it may not make sense to interfere with the arbitrage mechanism that provides the economic linkages between the cash and derivative markets during times of quickly moving markets. Interfering with the economic linkage during times of stress may mean that the hedges do not work as they should, causing unexpected and painful losses to investors. The stability provided by liquidity providers in one segment of the market may not help stabilize other sectors if the linkages are disrupted.

There are better ways of managing volatility than kludges like 200(e) and other circuit breakers. The time to examine them is now, during times of quiet markets, rather than in the aftermath of the next crash.

Sincerely,

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