Gentlemen:

From 1981 through 2002, I was an industry professional. Since then, I have written extensively about the stock market and in particular, the effects of so-called "naked short selling," Reg. SHO, the Threshold list, the contemplated changes in the price test and short selling in general. I consider myself an expert on stock market mechanics.

It is my firm belief that the short sale mechanics of the U.S. stock market are broken, almost to a point beyond hope for repair. The sheer number of comments the SEC has received on this matter should indicate that the problems are real and are damaging investors. Over the last two years, since shortly after Reg. SHO commenced, media coverage, both in print and broadcast, have voiced concerns. If the SEC refuses to listen or to take action, these problems will worsen and eventually, I would expect capital to flee our markets for safer havens.

The principal point in this argument is that listed companies have finite shares issued and outstanding for good reason. With all other factors equal and no other changes in assets, earnings, etc., if a company's capitalization is reduced, each remaining share must be worth more. With all other factors equal and no other changes in assets, earnings, etc., if a company's capitalization is increased, each share must be worth less.

If open-ended capitalizations were possible, theoretically, there would be no way to definitively value a share of stock. Yet, for many companies, that is the situation today. Naked short sales are the most obvious factor but all short sales tend to produce the same result - a forced increase in capitalization beyond what the company has stated is issued and outstanding.

A simple examination of the companies listed on the various Threshold lists over the last two years shows many instances of extended stays. It appears that market maker exemptions are responsible for a large portion of naked short sales, particularly in those situations where heavily shorted stocks become hard to borrow. As a result, short sellers may elect to purchase put options as their most effective means of betting on a price decline. If short sale interest is high, more puts will be purchased and more shares will be shorted without the requisite borrow. Theoretically, there is no limit to how many puts can be purchased, despite finite capitalizations.

Rather than retain a naked exposure to puts they have sold, market makers are likely to use their exemption to short the shares without first borrowing them. *Theoretically, if there is no limit on the number of puts that can be purchased, there is also no limit to the number of shares that can be shorted using exemption privileges.*

The buyer believes he has purchased shares, but has only purchased "share entitlements." In effect, shares are created out of thin air. If the phenomenon were temporary, it might be acceptable. However, when the process of a fair and timely delivery is delayed beyond a reasonable time, or is corrupted as one failed position is simply replaced by another, it is clear that more shares are trading than have been authorized. The most basic tenet of economics is that an increase in supply equates to lower prices. When naked short sales take place in substantial quantity and are unresolved by timely deliveries, there must be an effect on the price of the company's stock. It will decline.

However, all short sales - naked or otherwise - tend to have the same effect.

The net result is that more shares are "owned" than actually exist, as "share entitlements" are placed in customer account, rather than genuine shares. In most cases, customers believe they own bona fide shares when in fact, they do not. They only have a beneficial interest in an entitlement and in the case of dividend paying stocks, do not even receive a dividend, but rather a payment-in-lieu of the bona fide dividend. As a result, the "shareholder" also loses the tax advantage that would accompany a bona fide dividend.

Worse yet, the one share one-vote system has now been completely corrupted by extensive short sales and companies now routinely suffer votes well in excess of those authorized. In a close vote, there is now no way to verify a result. Clearly, if a company has 1,000,000 shares issued and outstanding, if 1,100,000 votes can be cast, something is dreadfully wrong.

One wonders whom the current system favors. Shareholders? How? If capitalization can be effectively increased, and the tax advantage of a qualified dividend lost, and the right to a full vote for each share "owned," how can the case possibly be made that shareholders are favored?

It is my belief that Prime brokers have exacerbated and corrupted the short sale mechanics of our markets in the quest for profits. Via the hypothecation of securities in margin accounts, firms are legally entitled to remove securities from a customer's account, leaving only an "IOU," as the share is then borrowed but sold by a short seller. However, the removed and shorted share may enter another customer's account and eventually make an identical exit. *Theoretically, the same share may be sold over and over again. Theoretically, there are no limits to the number of shares that may be shorted. Theoretically, the number of issued and outstanding shares is for all intents and purposes, useless. What are we to make of the U.S. stock market if the capitalizations of our listed companies cannot be trusted?*

The first and most obvious step for the SEC to take is to rein in the effects of naked short sales by limiting the number of puts that can be sold, dependent upon individual company capitalizations.

The second step is to immediately end the "Grandfathering" of pre-SHO failures-to-deliver. There would seem to be zero rationale to permit a failed delivery of shares to remain in place for a period measured in years, rather than days.

The third step would be to finally enforce the rules, so that companies cannot remain on the list for unreasonable lengths of time. Since failure A is all to often replaced by failure B and subsequently by failure C, ad infinitum, we have created an environment where companies can remain on the list forever, with their effective capitalizations increased to whatever degree beyond what the company intended. How can there be any doubt that shareholders are cheated under these circumstances?

The fourth step would be to keep the old price test in place. Allowing short sales without deliveries and on downticks simply compounds the problem and opens the door for abuse by parties who are interested in driving down the price of a security.

The fifth step would be to undertake a serious academic study of our short sale mechanics to determine the long-term effects it may have on our capital markets and our ability to compete against foreign capital markets in the future. I strongly believe we have created a circumstance that favors those who are able to target companies for destruction, primarily by single mindedly and purposely inflating the supply of shares available to trade.

In effect, we have placed the most basic premises of economic theory in doubt. If that doubt is left unresolved, we should expect the ramifications to affect the capital markets and for those ramifications to worsen over time.

Alan M. Newman

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