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Re: Amendments to Regulation SHO- File No.S7-12-06

The International Association of Small Broker-Dealers and Advisors www.IASBDA.COM submits the following comments on those aspects of the release regarding the locate requirement. The association believes that it has been the main cause of naked shorting and that a simple fix is available in the former NASD version of the requirement. Simply stated the failure to deliver on a short sale should be deemed a violation of the rule with the burden than shifting to the seller to explain mitigating circumstances. The following history of the locate requirement is necessary to grasp how it has become the mother of all loopholes.

Given the amount of current discussion on this topic some may wonder how the sophisticated system of regulation in the U.S. allows this to occur. Why is it not systematically prevented at the time of the trade. In other words why not force the borrow or put an automatic check in place. The history of how the idea of a locate rather than an actual borrow evolved suggests that Reg SHO inadvertently weakened the borrow requirement. We will use FR cites to avoid cumbersome citations and etb to reference the easy to borrow list.. We begin with proposed rule 10b-21 in 1973 which said you had to borrow or *have reasonable grounds to believe the stock could be borrowed.41 Fr 56530* This rule was withdrawn but followed by former SEC Commissioner Pollock's famous study in 1986 that resulted in NASD short sale regulation. *Short Sale Regulation of Nasdaq Securities by Irving Pollack*. The report specifically recommends that a borrowing requirement for delivery by brokers should be adopted because there was no automatic check on borrowing. Report at pp.68-69.There is no discussion in the report of anything less than an actual borrow which is clearly what the report intended.

Subsequently however in 1994,a modest proposal by the NASD, 59 FR 40931 set off a sequence of events that weakened the borrow requirement. At that time the NASD proposed to require its members to annotate the affirmative determination in place with specifics as to where the borrow was coming from when the customer assured delivery or the member located the stock. It noted that blanket assurances or lists were not acceptable. Most importantly for this discussion, if the borrow did not materialize, the member was in violation unless it could explain mitigating circumstances. So no delivery =violation. Thus the affirmative determination was more than just finding the stock.

The SEC approved the rule, 59 FR 47965, but then a strange thing happened when the NASD came back and said maybe it wasn't such a good idea. The following year the NASD returned with a request to delay the rule because of the prohibition on blanket assurances which allowed the customer to use a *faxed list* to assure the member that the stock was available.60 FR 49307. The NASD was concerned that the prohibition of daily fax sheets, the predecessor of the etb list may have created an unnecessarily burdensome regulatory requirement. The following year, the NASD blessed the use of such blankets as long as they were less than 24 hours old and *delivery actually occurred*. 61 FR 1805.(proposed) 61 FR 7127 (approved.) Thus the easy to borrow list was blessed, but only if you delivered. Indeed the affirmative determination rule did not use the word locate until the 1994 proposal to annotate stated: "If the member or associated person *locates* the stock, an annotation must be made that identifies the individual and firm contacted who offered assurance that the shares would be delivered or would be available by settlement date; and the number of shares needed to cover the short sale. *Thus the specific borrow requirement was converted to a mere listing of available securities. But note that the use of the word locate presupposed that if you didn't borrow there was a violation and that a locate alone was not enough to do the short.* A final example of the softness of the locate requirement is the fact that when a lender does not deliver there appears to be no requirement to try another lender. Why because you located and that's all you need to do. Surely more is required if naked shorting is to be taken seriously.

Interestingly enough the next event was the SEC's Concept Release on Short Sales in 1999, 64 FR 57996, which surprisingly did not mention these issues of blankets, lists and locates. The NASD was however not done yet and in the year 2000 they added the Hard to Borrow list to the short sellers arsenal,65 FR 16993, which required an attestation that stock not on the hard to borrow list was easy to borrow. The NASD was arguably diminishing the rule, but remember that they still considered a failure to deliver a violation *absent mitigating circumstances.* Despite avoiding the issue in the Concept Release, *when* the SEC proposed Reg SHO, 68 FR 62972, it was focused on the so called locate requirement. It begins its discussion by stating "the SRO's have generally adopted rules requiring that prior to effecting short sales members must "locate stock available for borrowing." but its citation at fn 35 is to its own proposed but withdrawn Rule 10b-11. That Rule however does not use the word locate but used the language *had reasonable grounds to believe the stock could be borrowed*. This language has been assumed to mean less than a borrow but it could also more logically be a defense to a borrow that the lender failed on. In other words if you borrowed but your lender failed, reasonable grounds existed. This conflation of affirmative determination with locate are

deep in the footnotes of Reg SHO and require viewing them in their entirety . Comparing the changes shows that the SEC in Reg SHO changed the automatic violation of NASD Rule 3370 to a less rigorous standard of reasonable grounds. In footnote 59 the commission noted:

"According to the current NASD "affirmative determination" rule, the manner by which a member or person associated with a member annotates compliance with the affirmative determination requirement is to be decided by each member. Members may rely on "blanket" or standing assurances (i.e., "Easy to Borrow" lists) that securities will be available for borrowing on settlement date. For short sales executed in Nasdaq National Market ("NNM") or exchange-listed securities, members also may rely on "Hard to Borrow" lists identifying NNM or listed securities that are difficult to borrow or unavailable for borrowing on settlement date provided that: (i) any securities restricted pursuant to NASD Rule 11830 must be included on such a list; and (ii) the creator of the list attests in writing (on the document or otherwise) that any NNM or listed securities not included on the list are easy to borrow or are available for borrowing. Members are permitted to use Easy to Borrow or Hard to Borrow lists provided that: (i) the information used to generate the list, is no more than 24 hours old; and (ii) the member delivers the security on settlement date. Should a member relying on an Easy to Borrow or Hard to Borrow list fail to deliver the security on settlement date, the NASD deems such conduct inconsistent with the terms of Rule 3370, absent mitigating circumstances adequately documented by the member. See NASD Rule 3370(b)(4)(C).

In footnote 58 the commission explained "A broker-dealer(under Reg. SHO) may obtain an assurance from a customer that such party can obtain securities from another identified source in time to settle the trade. This may provide the "reasonable grounds" required by Rule 203(b)(1)(ii). However, where a broker-dealer knows or has reason to know that a customer's prior assurances resulted in failures to deliver, assurances from such customer would not provide the "reasonable grounds" required by 203(b)(1)(ii). The documentation required by Rule 203(b)(1)(iii) should include the source of securities cited by the customer. The broker-dealer also should be able to demonstrate that there are "reasonable grounds" to rely on the customer's assurances, *e.g.*, through documentation showing that previous borrowings arranged by the customer resulted in timely deliveries in settlement of the customer's transactions.

The NYSE has interpreted this language to allow one bite of the apple, ie reasonable grounds do not exist after one failure. However until we see some

enforcement actions defining reasonableness, firms have plenty of leeway to show a reasonable reliance and proving unreasonableness has always been a challenge. Moreover any challenge to a customer allows the customer to go to another broker who has no reason to doubt the customer's reliability just as he can do when he hits the threshold list limit. This evolution from a specific requirement to contact the lender for specific shares- to reviewing a list is probably best explained in two words *trading acceleration or another two words hedge funds.* Since 1994 advanced technology has pushed trading to super sonic speed such that individual contacts with lenders have become outmoded. But in becoming outmoded it has also become more conducive to naked shorting justified by the speed of the marketplace. Who doubts that a profitable trade will not be given up simply because the borrow is uncertain, for what is uncertainty if its etb listed? In a recent blog former hedge fund trader and current NBA owner Mark Cuban admitted that naked shorts were not good because they allowed some short sellers to avoid the costs of shorting.http://www.blogmaverick.com/entry/1234000230033533/ See also professor Leslie Boni's study on opportunistic fails. Today a fail to deliver is not an automatic violation -but a question as to how reasonable/reliable was the locate. In fast moving markets the short sellers have been given the opportunity to assume that everything on the list is available for delivery, which cannot be true if the lenders are not decrementing the list. If its on the list their obligation is satisfied and to prove otherwise the regulators must show they acted unreasonably. We believe the word locate comes from its use in the '34 act to mean a safe location i.e. the stock has not only been found but actually has been lent to the short seller. The SEC should therefore return it to its original meaning by reviving the NASD'S language.

The release asks a number of penetrating questions regarding how to strengthen the locate requirement like requiring lenders to decrement their position when they indicate stock is available. But adding to the complexity of Reg SHO will only harm the regulators' ability to enforce it. The NASD settled approximately 80 cases under its language but did not impose large enough sanctions. In retrospect a mistake was made in allowing a borrow requirement to become a locate requirement. The simple answer to naked shorting is to require the sellers to borrow, reserve to borrow or face a violation unless they have an excuse. The rule can also be easily enforced by requiring firms to explain the reason for all failed short sales over a given time period during an examination. While some will argue that strict enforcement reduces liquidity, liquidity based on fails is a prescription for systemic failure and unfairness to issuers.