State of Connecticut

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Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

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

Dear Ms Morris:

I submit these comments in response to the Commission's request for comments on proposed amendments to Regulation SHO under the Securities Exchange Act of 1934. The Commission proposes to amend Regulation SHO by eliminating its so-called "grandfather" exception and narrowing the scope of the options market maker exception. These changes will make Regulation SHO significantly more effective in addressing the potential for abusive practices such as "naked" short selling. I applaud the Commission's effort to address shortcomings of the original regulation.

Although the proposed amendments are needed, I strongly urge the Commission to take additional stronger regulatory measures to combat market abuses and to protect investors, particularly in the still effectively unregulated field of hedge funds. Even if amended, Regulation SHO does not go far enough to protect against naked short selling, which remains too easy and too attractive to would-be manipulators. Therefore, in addition to the proposed amendment, the Commission should urgently consider more effective enforcement measures and tighter requirements on demonstrating actual borrowing of a security before a short sale may be effected.

Background

Regulation SHO sought to address a growing problem of failures-to-deliver stock by the trade settlement date generally and of abusive naked short selling in particular. As the Commission determined when it promulgated Regulation SHO, there was and continues to be substantial and compelling evidence that a significant number of failures-to-deliver have no adequate or legitimate justification. Some may not involve, for

example, an unintentional processing delay causing a failure-to-deliver in the normal three day settlement period -- but rather are evidence of substantial abusive practices in which short sales are made without any intention to borrow the stock for such sales or to in fact deliver the stock. *See* SEC Release No. 34-48709. These naked short sales may be used to fraudulently manipulate the stock price.

The mechanism the Commission chose to combat such abusive practices was to impose a "close-out" requirement for failures-to-deliver in "threshold securities." A threshold security is one in which there is a number of failures-to-deliver that have exceeded a prescribed threshold.[1] The close-out requirement requires a fail to deliver position that has persisted for 13 consecutive settlement days to be closed out immediately by purchasing securities of like kind and quantity. 17 C.F.R. § 242.203(b)(3). Until such positions are closed out, the clearing agency participant and broker-dealer for which it clears transactions may not participate in any further short sales of the security without first either actually borrowing the security or entering into an arrangement to borrow. 17 C.F.R. § 242.203(b)(3)(iii).

Grandfather Exception

A substantial, and misconceived, exception was established to the close-out requirement for fail to deliver positions that were established ***prior*** to the security becoming a threshold security. 17 C.F.R. § 242.203(b)(3)(i). In other words, a fail to deliver position was not subject to the close-out requirement if the position was established before the number of such positions had exceeded the threshold criteria even if, shortly thereafter, that criteria was met. The Commission adopted this so-called "grandfather" exception because of a concern about creating price volatility and "short squeezes" (the upward pressure on stock price if short sellers are forced to cover their positions) if a large number of existing fail to deliver positions had to be closed out quickly. SEC Release No. 34-54154, at 7.

The original justification for the grandfather exception was not persuasive at the time of its adoption, and as the Commission now recognizes, the evidence fails to support it. Although the experience since the adoption of Regulation SHO demonstrates that failures-to-deliver have been reduced without market disruption, there continues to be a number of certain securities with substantial fail to deliver positions that persist. This situation can be substantially attributed to the grandfathering exception.

The Commission now proposes to eliminate the grandfather exception so that all fail to deliver positions in a threshold security would be subject to the close-out

[1] Specifically, Regulation SHO defines a threshold security in which there is an aggregate fail to deliver position for five consecutive settlement days of 10,000 or more shares equaling at least 0.5% of the total outstanding shares. 17 C.F.R. § 242.202(c)(6).

requirement regardless of when the position was established. The elimination of the grandfather exception is fully warranted and should be adopted.

First, the experience since the adoption of Regulation SHO demonstrates that the Commission's concerns about possible market disruption were unfounded. The evidence, as the Commission itself has found, reflects little price volatility resulting from the imposition of the close-out requirement. SEC Release No. 34-54154, at 8 & n.18. There is no reason to believe that there would be any different result if the close-out requirement is imposed on all fail to deliver positions simply because some positions were established before rather than after the stock was designated a threshold security. Regulation SHO, without the grandfather exception, is already tailored to avoid negative market effects. After all, the close-out requirement only applies to threshold securities, which by definition are securities that have a very high level of persistent failures-to-deliver.

Second, the persistence of fail to deliver positions in certain securities strongly suggests that abusive and manipulative practices such as naked short selling continue to take place. The grandfather exception rendered Regulation SHO a half-measure, providing a wide gap in which manipulators could continue to operate. There is no justification for leaving this gap open.

Third, eliminating the grandfather exception will go a long way in restoring investor confidence. As the Commission is well aware, there have been a number of high profile matters involving allegations of naked short selling, most if not all of which have involved hedge funds. The continuing persistence of fail to deliver positions permitted by the grandfather exception sends the unfortunate and unnecessary signal to the investing public that the securities laws are inadequate to address this urgent problem. Eliminating the grandfather exception is essential to assuring investors that this is not the case.

Further Measures

The proposed amendment eliminating the grandfather exception will without question improve the efficacy of Regulation SHO.[2] However, this remains but one step in a series of measures that must be considered to address naked short selling -- and a host of other abusive practices.

There is no convincing case for not requiring actual borrowing prior to effecting a short sale. Regulation SHO took the rather timid step of imposing a "locate"

[2] The second proposed change to Regulation SHO is to narrow the options market maker exception. This amendment appears to strike a better balance between the need to reduced failures-to-deliver and the need to avoid adverse consequences in the liquidity and pricing of options

requirement. Specifically, Regulation SHO created a uniform rule requiring a broker-dealer, prior to effecting a short sale, to locate securities available for borrowing. All that this locate requirement demands of the broker-dealer to do is, in the absence of actually borrowing the security, to have "reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due." 17 C.F.R. § 242.203(b)(1). The Commission adopted this limited locate requirement out of concerns for *maintaining flexibility and liquidity in short sales*. The locate requirement is an effectively unenforceable barrier to abusive practices.

The Commission should reconsider its views on an actual borrowing requirement. Obviously, an actual borrowing requirement will directly and effectively address naked short selling -- a short sale could not be effected without actually having borrowed the security. Against these clear benefits, the costs of an actual borrowing requirement remain speculative. Regulation SHO already imposes a limited "pre-borrowing" requirement for threshold securities.[3] To gain experience to evaluate the impacts, both positive and negative, of an actual borrowing requirement, the Commission could consider imposing such a requirement on "sub-threshold" securities -- that is, securities in which there are a significant number of failures-to-deliver but not yet satisfying the criteria for threshold status. Experience with such a requirement may very well show that the Commission's concerns are unjustified and that an actual borrowing rule not only could be imposed on all short sales, but will be a far more effective regulatory measure.

Second, the penalties for violating Regulation SHO need to be more than just the "cost of doing business." The Commission must consider crafting specific penalties for violations of Regulation SHO. Currently, the only "penalty" for not closing out a fail to deliver position is requiring pre-borrowing for any further short sales in the threshold security until the position is closed out. Although an appropriate requirement, because it is limited to trading in the threshold security, it does little to either (a) deter illicit short sales, or (b) ensure that fail positions are closed out. This lack of effective penalties or enforcement mechanisms to ensure close-outs take place contributes to the persistence of failures-to-deliver in certain securities.

The importance of ensuring close-outs is not only a matter of policing against naked short sales. As the Commission has acknowledged, "large and persistent fails to deliver can deprive shareholders of the benefits of ownership, such as voting and lending." SEC Release No. 34-54154, at 8. The Commission must have a meaningful penalty and enforcement mechanism to create appropriate economic incentives so that failures-to-deliver, are reduced.

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[3] Until the close-out requirement is satisfied by a participant of a clearinghouse or a broker-dealer holding a fail position on a threshold security for thirteen consecutive settlement days, any further short sale by such participant or broker-dealer is barred unless the security is actually borrowed or an arrangement to borrow the security has been entered into. 17 C.F.R. § 242.203(b)(3)(iii).

Finally, the Commission must address the elephant in the room: hedge funds. There is mounting evidence that some traders -- including hedge funds -- engage in the practice 'short and distort' They take a short position on a stock and then use investment advisors beholden to them to issue misleading stock analysis in order to cause the price of a stock to decline, enabling the hedge fund to garner excessive profits and costing unsuspecting investors millions of dollars.

Lack of transparency and oversight contributes to the danger that hedge funds may engage in possible use of naked short selling. Thus, Regulation SHO must be viewed in the broader context of necessary review of supervisory approaches to the hedge fund industry.

This concern seems particularly pertinent in light of the phenomenal growth and retailization of hedge funds -- expanding beyond sophisticated wealthy investors to include pension funds, charitable organizations and middle income investors. Hedge funds have been exempt from disclosure requirements because they have been viewed as solely private investment vehicles for investors with significant financial resources and presumed knowledge. The conventional wisdom was that these investors, by virtue of their financial means, were so sophisticated and knowledgeable that they did not need federal regulations to protect them from fraud or abuse. These assumptions have eroded in recent years as hedge funds and funds-of-funds are increasingly retailed and marketed to a broader group of investors. This growth compels a new approach.

Particularly in light of the recent ruling in *Goldstein v SEC*, invalidating the Commission's minimal hedge fund registration requirements, new efforts must be made to improve disclosure and accountability standards in the hedge fund industry. Reform should include requiring appropriate disclosure and perhaps raising the threshold levels of assets mandated for qualified investors. Greater transparency will enhance investor confidence in this increasingly important and influential part of the market.

The Commission is right to reexamine the level of regulation and transparency in hedge fund activities. Short sales comprise only one area where greater transparency is needed. I therefore strongly urge the Commission to continue the effort -- reflected in Regulation SHO -- into the many other areas of growing concern relating to hedge funds.

Very truly yours,

RICHARD BLUMENTHAL

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