

1 UNITED STATES SECURITIES AND EXCHANGE COMMISSION

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4 SECURITIES LENDING AND

5 SHORT SALE ROUNDTABLE

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12 DATE: Wednesday, September 30, 2009

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16 The above-entitled matter came on for hearing,

17 pursuant to notice, at 9:33 a.m.

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## 1 P R O C E E D I N G S

2 CHAIRMAN SCHAPIRO: Good morning. Welcome today to  
3 day two of the Securities and Exchange Commission's  
4 Securities Lending and Short Sale Roundtable, which will  
5 focus on short sale issues.

6 First, on behalf of the Commission, let me thank  
7 all of you who've agreed to participate today. Our  
8 consideration of these important short selling issues will be  
9 enhanced by what I expect will be informative and interesting  
10 comments, insights, and recommendations by our panelists.

11 During my tenure as Chairman, the issue of short  
12 selling has been the subject of numerous inquiries,  
13 suggestions and expressions of concern to the Commission. We  
14 know that the practice of short selling evokes strong  
15 opinions from both its supporters and detractors. I have  
16 made it a priority to evaluate the issue of short selling  
17 regulation and ensure that any future policies in this area  
18 are the result of a deliberate and thoughtful process, which  
19 is why we're here today.

20 Today's roundtable discussion includes two panels.  
21 Each panelist will take a few minutes to share his or her  
22 thoughts on the issues being discussed, and when these  
23 introductory statements are complete, the floor will be  
24 opened to questions from the Commission.

25 The first panel will consider the merits of

1 imposing a pre-borrow or "hard locate" requirement on short  
2 sellers, either permanently or on a pilot basis. The panel  
3 will also consider the alternative forms that a pre-borrow or  
4 hard locate requirement could take to enhance its  
5 effectiveness and benefit to investors.

6           Among the many inquiries, suggestions, and  
7 expressions of concern that the Commission has received  
8 concerning short selling, and particularly "naked" short  
9 selling, many have recommended that the Commission impose a  
10 requirement that anyone effecting a short sale must borrow or  
11 arrange to borrow the securities prior to effecting a short  
12 sale.

13           The Commission is concerned about abusive naked  
14 short selling and persistent fails to deliver, and the  
15 potentially manipulative effect this activity can have on our  
16 markets. Thus, we are examining whether a pre-borrow or hard  
17 locate requirement or another alternative is necessary or  
18 would be effective in addressing such activity and preventing  
19 problems in the marketplace.

20           The discussion will take into account the  
21 Commission's existing "locate" requirement under Reg SHO,  
22 which requires broker-dealers, prior to effecting a short  
23 sale, to borrow or arrange to borrow the securities, or have  
24 reasonable grounds to believe that the securities can be  
25 borrowed so they can be delivered on the delivery date.

1           The discussion will also consider the impact of  
2 temporary Rule 204T, and now final Rule 204, which requires  
3 clearing firms to purchase or borrow shares to close out a  
4 fail to deliver resulting from a short sale by no later than  
5 the beginning of trading on T + 4.

6           The second panel will consider additional  
7 measures -- additional means to foster short selling  
8 transparency so that investors and regulators have greater  
9 and more meaningful information about short sale activity.  
10 The panel will consider enhanced disclosure methods such as  
11 adding a short sale indicator to the Tape to which  
12 transactions are reported for exchange-listed securities, or  
13 requiring public disclosure of individual large short  
14 positions.

15           In the fall of 2008, the Commission adopted a  
16 temporary short sale reporting rule, Rule 10a-3T. The rule  
17 required certain market participants to provide short sale  
18 and short position information to the Commission.

19           Instead of renewing the rule, the Commission and  
20 its staff, together with several SROs, determined to  
21 substantially increase the public availability of short  
22 sale-related information by publishing, on a daily basis,  
23 aggregate short selling volume data in each individual equity  
24 security and, on a one-month delayed basis, publishing  
25 information regarding individual short sale transactions in

1 all exchange-listed equity securities.

2 In addition, the Commission has enhanced the  
3 publication on its website of fails to deliver data so that  
4 such information is provided twice per month and provided for  
5 all equity securities, regardless of the fails level.

6 Today's panel discussion will consider whether  
7 additional public or non-public disclosure of short selling  
8 transactions and short positions would be beneficial, and if  
9 so, what type of disclosure should be implemented. I am also  
10 particularly interested to hear about the experiences in  
11 foreign jurisdictions, such as the United Kingdom, that have  
12 implemented short sale reporting regimes.

13 Today's panelists are leaders and experts in their  
14 respective fields. They represent a range of constituencies  
15 that includes issuers, financial services firms,  
16 self-regulatory organizations, foreign regulators, investors,  
17 and the academic community. It's a privilege to have them  
18 here, and we look forward to an informative and interesting  
19 discussion.

20 I'll be happy now to turn the meeting over to Jamie  
21 Brigagliano, Acting Co-Director of the Division of Trading  
22 and Markets, who will introduce and moderate our first panel.

23 Jamie.

24 MR. BRIGAGLIANO: Thank you, Chairman Schapiro.

25 We will now begin the day's first panel, titled

1 Controls on Naked Short Selling: Examination of Pre-Borrow  
2 and Hard Locate Requirements. Following introductions, the  
3 panelists will each make a brief opening statement. Because  
4 we have a lot of information to cover in a relatively short  
5 amount of time, we ask that panelists limit their opening  
6 statements to no more than three minutes.

7           Following opening statements, the panel will  
8 receive questions from the Chairman and Commissioners. While  
9 responding to questions from the Chairman and Commissioners,  
10 panelists are encouraged to engage in a dialogue with one  
11 another. We welcome discussion of other panelists'  
12 viewpoints, differing opinions, and additional thoughts in  
13 response to other panelists' remarks.

14           Before we begin, I would like to welcome and  
15 introduce our distinguished panel.

16           William Conley is Managing Director of the Equities  
17 Division of Goldman Sachs.

18           Peter Driscoll serves as the Chairman of the  
19 Security Traders Association.

20           Dr. Frank Hatheway is the Chief Economist of the  
21 NASDAQ OMX Group, Inc.

22           William Hodash is the Managing Director for  
23 Business Development at the Depository Trust & Clearing  
24 Corporation.

25           Paul Lynch is Senior Managing Director and Head of

1 Global Trading for the Securities Finance Division of State  
2 Street Corporation.

3 Michael Mendelson is the Director of Global Trading  
4 Research for AQR Capital Management.

5 Dennis Nixon is the President and CEO of  
6 International Bank of Commerce and Chairman of International  
7 Bancshares Corporation.

8 William O'Brien is the Chief Executive Officer of  
9 Direct Edge, the third-largest equities marketplace in the  
10 United States.

11 Thomas Perna is Chief Executive Officer of  
12 Quadriserv.

13 Bill Conley, would you like to get us started?

14 MR. CONLEY: Thank you.

15 I'd like to start by thanking the Chairman,  
16 Commissioners, and members of the staff for the invitation to  
17 join today's panel. This panel has been asked to address  
18 topics that would likely have considerable impact on market  
19 structure, liquidity, and efficiency. We appreciate the  
20 opportunity to join the discussion.

21 We believe that the available evidence does not  
22 support the need for any form of pre-borrow or hard locate.  
23 The Government Accountability Office confirmed in its May  
24 2009 Report on Regulation SHO that 99.9 percent of daily  
25 transactions in U.S. equity securities, by dollar value,

1 clear and settle within the standard three-day settlement  
2 period.

3           This data confirms that current regulations,  
4 including Rule 204 of Regulation SHO, are the most effective  
5 ways to control abusive short selling. Rule 204 requires  
6 clearance brokers to close out any delivery that does not  
7 settle in the prescribed settlement period.

8           In the case of short sales, the mandatory closeout  
9 period is one day after contractual settlement. Our review  
10 of CNS fail data suggests that fail rates have declined over  
11 80 percent since the implementation of the mandatory closeout  
12 provisions.

13           The time and cost associated with a pre-borrow or  
14 hard locate requirement should be carefully considered if the  
15 objective is to increase timely settlement only by 0.1  
16 percent.

17           Both pre-borrow and hard locate requirements will  
18 require significant expense to the industry and its  
19 participants.

20           At a minimum, pre-borrow requires the funding of  
21 the borrow begin on trade date instead of settlement date.  
22 In this regard, it is important to note that short sale  
23 proceeds are not available to clearance brokers until  
24 settlement date, requiring the clearance brokers to fund the  
25 pre-borrow out of their own capital.



1           For example, in the wake of the July 15, 2008 SEC  
2 emergency order that resulted in pre-borrows on 19 covered  
3 financial stocks, broker dealer balance sheet impacts of up  
4 to \$2 billion on those securities in particular for pre-  
5 borrows were reported.

6           Only a small percent, estimated to be less than 5  
7 percent, of all locates result in the need to borrow.  
8 Consequently, pre-borrows would needlessly drain supply from  
9 the securities lending market, which would result in reduced  
10 liquidity.

11           The costs associated with short selling will rise.  
12 Pre-borrows or other reservations of stock will result in  
13 fees being paid by borrowers to lenders, and that will be  
14 passed along to short sellers.

15           Both a pre-borrow and hard locate requirement would  
16 require significant infrastructure builds on the part of the  
17 industry as well as its participants. For example, a hard  
18 locate concept that has been circulated would require every  
19 executing broker, clearing and prime broker, custodian, agent  
20 lender, and DTCC to build or modify systems.

21           A pre-borrow or hard locate requirement can be  
22 expected to have minimal impact on abusive naked short  
23 selling because an entity that engages in this activity does  
24 not comply with locate requirements, nor does it seek to make  
25 delivery when it's due. Pre-borrow and hard locates serve to

1 add cost and complexity that impacts those who are already  
2 complying with regulations.

3           The implementation of the mandatory closeout  
4 provision of Rule 204 has largely eliminated fails. That  
5 said, we recommend that the Commission move forward with the  
6 adoption of the revised prime brokerage no-action letter,  
7 which has been submitted on behalf of the industry by SIFMA.

8           The framework outlined in this letter provides for  
9 enhanced order marking (long versus short), customer  
10 positions to support long sales, and locates, but most  
11 importantly requires communication between prime brokers and  
12 executing brokers when certain discrepancies are detected.

13           In summary, Section 10 of the revised letter  
14 requires notification of order marking discrepancies (long  
15 versus short). Section 11 requires the validation of  
16 positions on long sales. Section 12 requires the prime  
17 broker to validate locates on short sales.

18           Any discrepancy not resolved with the customer must  
19 be reported to the executing broker. The executing broker  
20 must consider this information in determining subsequent  
21 transactions with the customer.

22           These procedures are specifically targeted at  
23 ferreting out anyone who attempts to engage in abusive naked  
24 short selling. Thank you.

25           MR. BRIGAGLIANO: Thank you, Bill.

1 Peter Driscoll?

2 MR. DRISCOLL: Good morning. My name is Peter  
3 Driscoll. I'm the current Chairman of the Security Traders  
4 Association. The STA is a professional trade organization  
5 that provides a forum for our traders to share their unique  
6 perspective on issues facing the securities markets.

7 Our members work together to promote investor  
8 protection and efficient, liquid markets. The STA  
9 appreciates the opportunity to share our opinions on short  
10 selling regulation in general and abusive or naked short  
11 selling in particular.

12 We believe that the Securities and Exchange  
13 Commission should be applauded for the development and  
14 implementation of Regulation SHO. The Commission went to  
15 great lengths through the regular notice and comment  
16 rulemaking process, and an extended pilot implementation, to  
17 ensure that all points of view and relevant facts were  
18 examined, and that the new rule was appropriate for the new  
19 market structure. We continue to believe that with some  
20 minor adjustments, Regulation SHO can effectively control  
21 abusive short selling, including naked short selling.

22 The STA believes that short selling is a  
23 legitimate, economically important activity that fosters  
24 price discovery and is a critical component of overall  
25 liquidity. We commend the Commission for focusing on the

1 balancing of costs and benefits of any additional short  
2 selling restrictions.

3           We are not aware of any evidence showing that  
4 restricting short selling would have eliminated naked or  
5 abusive short selling, increased investor confidence, or that  
6 the benefits of the new regulations would outweigh the  
7 additional costs they would impose.

8           We believe that Rule 204 has produced empirical  
9 evidence that the clearing and settlement function is the  
10 appropriate area on which to concentrate short sale  
11 restrictions. Implementation and enforcement of Rule 204 has  
12 reduced the number of stocks on the threshold list from 582  
13 in July of '08 to 63 issues one year later, a reduction of  
14 89 percent.

15           The STA has expressed concerns about the reasonable  
16 grounds to believe standard contained in Rule 203 of  
17 Regulation SHO, and recommends that the SEC undertake a  
18 review of Rule 203 and its interpretations to amend the  
19 rule's language and address any circumvention of the intent  
20 of the rule. Surgically altering the language and strict  
21 enforcement could provide significant results in the effort  
22 to control improper and abusive short selling, including  
23 naked short selling.

24           If the Commission believes that additional  
25 regulation is absolutely necessary, the Association would

1 suggest that the Commission review our circuit breaker  
2 elected pre-borrow proposal sent May 4th.

3           While the circuit breaker pre-borrow proposal would  
4 be a reasonable alternative to short sale price tests, it may  
5 not be a reasonable alternative to Rules 203 and 204 in an  
6 effort to address naked short selling. Placing a mandatory  
7 pre-borrow requirement on hard-to-borrow issues may restrict  
8 liquidity to an unreasonable degree and cause unwarranted  
9 price fluctuations in the issues trading.

10           The cost/benefit analysis will be extremely  
11 important when considering imposing a market-wide mandatory  
12 pre-borrow requirement. Implementing a market-wide permanent  
13 pre-borrow requirement would be very expensive.

14           As we have mentioned in previous comments, the  
15 breadth of the abusive short sale problem appears to be  
16 limited in nature, and a market-wide permanent solution would  
17 be inappropriate. Thank you.

18           MR. BRIGAGLIANO: Thank you, Peter.

19           Dr. Hatheway?

20           DR. HATHEWAY: Thank you, Jamie.

21           As Chief Economist for the NASDAQ OMX Group, the  
22 world's largest securities market operator, I'd like to thank  
23 you, Chairman Schapiro and Commissioners, for organizing this  
24 roundtable on securities lending and short sales.

25           Issues that list their shares on our markets and

1 investors that risk capital there demand rules that are  
2 soundly reasoned, clearly articulated, and rigorously  
3 administered to create a safe, fair, transparent, and  
4 efficient venue for securities trading.

5 My remarks today are similar in theme and content  
6 to those I made at the roundtable on May 5th. First, based  
7 on numerous studies of empirical data, the Commission has  
8 been quite successful over time in reducing fails to deliver.  
9 Second, the Commission achieved this success through  
10 incremental, narrowly tailored regulatory changes.

11 Third, the Commission should continue to focus on  
12 reducing fails to deliver and abusive short selling, and  
13 continue using its proven approach, careful analysis of  
14 empirical data followed by incremental regulatory responses.

15 The requirements of Rule 204T and the subsequent  
16 Rule 204 focused on issues associated with the delivery of  
17 borrowed shares. As we turn today to the practices involved  
18 in the lending process and consider strengthening the locate  
19 or creating pre-borrow requirements, it is important to know  
20 whether there is evidence of continued abuse in the stock  
21 loan market or if there are shortcomings in the enforcement  
22 regime which have not been addressed by Rule 204, if that's  
23 the case -- or, excuse me, if that is not the case, one  
24 course for the Commission is to monitor potential loopholes  
25 in existing regulations for signs of abusive conduct, much as

1 they did with fail to deliver.

2           Acting on the hypothetical possibility of abusive  
3 conduct and at the same time restricting beneficial liquidity  
4 oriented behavior in the market is not in the best interest  
5 of investors or listed companies. Barring reliable empirical  
6 evidence that steps taken to take have not been sufficient to  
7 prevent abuses in stock lending, we would encourage the  
8 Commission to closely monitor this area rather than taking  
9 regulatory action at this time.

10           Should the Commission believe, however, that there  
11 currently exists abusive conduct in the stock loan markets,  
12 we would support the Commission taking immediate and  
13 effective steps to close any existing regulatory gaps.  
14 NASDAQ OMX Chief Executive Officer Robert Greifeld has  
15 publicly urged the Commission to consider adopting a hard  
16 locate rule.

17           Under current rules, securities lenders are  
18 constrained in issuing locates by the risk of a short squeeze  
19 or other events that would simultaneously force delivery of  
20 all located shares. Borrowers are similarly constrained from  
21 accepting locates from unreliable lenders. The regulations  
22 do permit, however, firms to assess that risk on a stock-by-  
23 stock basis. Therefore, there may be gaps in the current  
24 locate practices.

25           A hard locate rule would augment current rules and

1 practices by placing a fixed regulatory limit on the number  
2 of locates per share firms could issue. The limits could be  
3 fashioned in a variety of ways: a fixed ratio; dollar volume  
4 of locates issued measured against the firm's capital, a  
5 relevant indicator; or a scale based on a characteristics of  
6 the stock, the firm making the loan, or general capital  
7 market conditions.

8           The essential feature of any hard locate rule,  
9 however, is substituting a regulatory limit to risk-based  
10 features used by the markets today. A well-constructed  
11 locate rule would be a powerful yet flexible tool for the  
12 Commission to reduce the costs of abusive short selling,  
13 while still preserving the benefits of price discovery and  
14 liquidity made possible by prudent lending.

15           The Commission should also consider differential  
16 requirements for market makers. Implementing a hard locate  
17 rule or other restriction on security lending will likely  
18 increase the cost of providing liquidity. Again, the  
19 empirical evidence should dictate the exact structure of this  
20 exemption.

21           NASDAQ OMX stands ready to assist the Commission in  
22 analyzing appropriate and necessary steps necessary to reduce  
23 fails to deliver and abusive naked short selling. As I  
24 stated earlier, the Commission should first determine whether  
25 sufficient empirical data exists to warrant further



1 tightening of lending through restriction on locates.

2           If the Commission can make that determination,  
3 NASDAQ believes that a hard locate rule, as described above,  
4 would be the most effective, flexible tool to balance the  
5 overall risk, cost, and benefits associated with short  
6 selling. Thank you very much.

7           MR. BRIGAGLIANO: Thank you, Dr. Hatheway.

8           Bill Hodash?

9           MR. HODASH: Thank you, Chairman Schapiro and  
10 Commissioners, for inviting DTCC to participate in today's  
11 roundtable.

12           As part of DTCC's mission, we are closely following  
13 discussions with regard to potential new regulations that may  
14 affect our customers with an intention to, wherever feasible,  
15 develop central tools that can support regulatory objectives  
16 while helping minimize their compliance costs.

17           Those who believe that naked short selling is a  
18 severe problem in the U.S. markets often cite fail to deliver  
19 statistics as an indicator of naked short selling activity,  
20 notwithstanding the SEC's own cautionary statements that  
21 there can be any number of reasons for fails, and that the  
22 existence of fails cannot automatically be construed as  
23 evidence of naked short selling activity.

24           Even bearing that caution in mind, recent trends  
25 and fails can suggest some conclusions about what's happening

1 in the markets. For the Commission's consideration, many in  
2 the industry believe a measure of the efficacy of Commission  
3 Rule 204T and Rule 204 in combating naked short selling may  
4 be the impact it has had on fails to deliver in CNS.

5 Thus, a look at the fail rates over the last year  
6 before and after the introduction of Rule 204T may be  
7 relevant to the discussion of whether naked short selling  
8 remains a problem. Clearly, these statistics suggest that  
9 the regulations have had a dramatic impact.

10 Now, these fail statistics are not about trades.  
11 They are about net obligations that are owed to the  
12 clearinghouse by its members. They include both long and  
13 short sales.

14 Fails during July of 2008 in CNS averaged  
15 1.09 percent of total daily value processed. Following the  
16 implementation of Rule 204T, fails dropped precipitously,  
17 averaging about 0.23 percent over the last three months of  
18 2008, and recently 0.16 percent for the month of July 2009.

19 Now, many in the industry feel that this low fail  
20 rate, combined with Rule 204's requirement to close out fails  
21 on T + 4, place appropriate back-end settlement date controls  
22 on fails resulting from naked short selling.

23 DTCC's current discussions with the Commission  
24 staff include a focus on naked short selling and the locates  
25 rules. Omgeo, a joint venture with Thomson Reuters, has been

1 working with SIFMA's prime brokerage committee for several  
2 years with regard to proposed amendments to the no-action  
3 letter on prime broker arrangements, and has held out its  
4 trade suite system for use in helping to identify any  
5 remaining short selling abuses by going well beyond relying  
6 on customer representations, focusing on identifying  
7 discrepancies between executing brokers and prime brokers  
8 regarding whether a sale was short or long, inventory issues  
9 on long sales, and locate issues on short sales.

10           In recent discussions we've had with industry  
11 members on these and related issues, including a concept put  
12 forth by a company named Global Locate Services, that calls  
13 for a phased approach to enhancing the locate's process  
14 beginning with post-trade monitoring and reporting, there has  
15 been initial industry reaction in three areas.

16           Those concerns are mainly, first, that the decrease  
17 in fails calls for, at a minimum, additional time to assess  
18 whether abusive short selling is still a problem. If abusive  
19 short selling remains a problem, then work is needed to  
20 identify whether locate practices contribute significantly  
21 to it.

22           If this determination is reached, industry members  
23 feel that the enhanced procedures called for in the draft  
24 amended no-action letter should be implemented and monitored.  
25 Then if it's determined that there is still a residual

1 problem, there may be a basis for considering additional  
2 proposals, and the industry is prepared to participate in  
3 that analysis.

4 In conclusion, DTCC stands ready to assist our  
5 customers with automated and centralized solutions that can  
6 help them meet any new or enhanced regulations, including any  
7 with regard to naked short selling, in a cost-effective  
8 manner.

9 By the nature of our governance, we will look for  
10 guidance from both the Commission and the industry before  
11 embarking on the development and implementation of any such  
12 tools.

13 MR. BRIGAGLIANO: Thank you, Bill.

14 Paul Lynch?

15 MR. LYNCH: Good morning. My name is Paul Lynch,  
16 and I'm the Senior Managing Director for State Street. I'm  
17 the Head of Global Trading and Risk Management for the Agency  
18 Lending Business, and the Head of our Enhanced Custody  
19 Product. I would like to thank Chairman Schapiro and the  
20 Commissioners for inviting me here today to discuss this  
21 important topic as financial markets continue to be shaped  
22 for optimal efficiency and transparency.

23 State Street Securities Finance is opposed to the  
24 proposal to impose new pre-borrow or hard locate requirements  
25 in connection with short selling for equity securities. We

1 support regulations that contribute to a more efficient short  
2 sale marketplace, including the Commission's now permanent  
3 Rule 204 of Regulation SHO.

4           We agree with the Commission's analysis that Rule  
5 204 has been -- had a positive impact. It has addressed the  
6 issue of naked short selling while preserving legitimate  
7 short selling activity. Given the success, we believe  
8 imposing additional pre-borrow or hard locate requirements is  
9 unnecessary. It will reduce the efficiency of short sales  
10 and have a number of unintended results.

11           Since asset managers are constantly adapting to  
12 changing economic environments and markets, a pre-borrow  
13 regulation in practice leads to multiple pre-borrows for  
14 every eventual short sale due to the many locates never  
15 materializing in a short sale.

16           Any type of pre-borrow activity that would encumber  
17 my clients' assets would require a form of borrowing fee for  
18 my client, whether or not a physical delivery was made. The  
19 result would be unnecessary utilization of inventory and  
20 increased fees from borrowers. Short-term, this would be  
21 beneficial to my firm and my clients. But long-term market  
22 consequences made adverse to all.

23           The long-term increased borrowing costs, the  
24 potential increased prime brokerage capital usage, the  
25 securities lending inventory illiquidity resulting from a

1 pre-borrow or hard locate requirement, could lead to a number  
2 of detrimental consequences for a legitimate short sale  
3 activity. As legitimate hedges and short sale strategies are  
4 restricted, market volatility will increase.

5 In summary, we believe a pre-borrow requirement  
6 could expose the market to detrimental consequences and  
7 provide no demonstrable improvement in market efficiency or a  
8 measurable impact on naked short selling beyond the  
9 Commission's existing policies and regulations. Thank you.

10 MR. BRIGAGLIANO: Thank you, Paul.

11 Michael Mendelson?

12 MR. MENDELSON: Chairman Schapiro, Commissioners,  
13 and staff, thank you for inviting me to appear before you.  
14 I'm a principal at AQR Capital Management, an investment  
15 management firm that manages assets for, among other, pension  
16 funds, endowments, and foundations.

17 Short selling is an important activity with many  
18 benefits. But a tiny portion of short selling is abusive  
19 naked short selling, a practice we oppose. Regulation of it  
20 should seek to maximize the benefit of constructive short  
21 selling while mitigating the problems associated with both  
22 benign failures to deliver and illegal manipulation. It  
23 should not ensnare the vast majority of short selling  
24 activity, for that will prove costly to legitimate investors,  
25 possibly without having any effect on the problems we are

1 trying to solve.

2 I had planned to promote the success of Rule 204,  
3 but at this point that would just be piling on. Rule 204 is  
4 well-targeted. Pre-borrow and hard locate proposals are  
5 unguided.

6 Pre-borrow requirements are ineffective and very  
7 costly. They will have little effect on someone who isn't  
8 bothering to get a locate now, and will require clearing  
9 brokers to forward cash collateral to lenders three business  
10 days before the proceeds from any short sale are available.  
11 This is an excessively expensive requirement whose costs will  
12 be paid by investors in the form of higher fees, increased  
13 trading costs, reduced prime brokerage competition, and  
14 greater market inefficiency.

15 Hard locate requirements are ineffective and  
16 excessively burdensome to investors. They do not suffer from  
17 the substantial funding problem of pre-borrow, but still  
18 force dramatic costs on the stock loan market that are not  
19 offset by gains in compliance or, I believe, improved  
20 investor confidence.

21 Hard locate requirements won't deter naked short  
22 sellers. They don't comply with locate rules. It will not  
23 accomplish the goal of eliminating fails since we cannot  
24 prevent the actual owner of the long security from selling;  
25 it will turn an automated, auditable process into a

1 cumbersome and costly function; it will substantially impair  
2 liquidity providers, and will create an economic value to  
3 locates where little or none has existed to date, leading to  
4 hoarding, additional costs to investors, and the potential  
5 for new manipulative practices. These same concerns apply to  
6 pre-borrow, too.

7           While I do not support pre-borrow or hard locates,  
8 the system can be improved. The Commission may wish to  
9 consider:

10           (1) Requiring clearing and executing brokers to  
11 conduct daily reconciliations of locates, including  
12 verification that locates were obtained before the time of  
13 sale and that sale orders were properly marked as long or  
14 short;

15           (2) Requiring executing brokers to determine which  
16 of their clients show a pattern or a practice of failing to  
17 deliver securities; and

18           (3) Requiring that short sellers employing  
19 exemptions from locate rules mark their orders with the  
20 specific type of locate exemption under which the stock is  
21 traded, and examine whether short sellers employing  
22 exemptions for the locate rules are using those exemptions  
23 for their intended purposes.

24           It is possible that many of the non-operational  
25 failures to deliver we see today are failures of this type.



1 For those interested, I have provided further detail in my  
2 written statement. Thank you.

3 MR. BRIGAGLIANO: Thank you, Michael.  
4 Dennis Nixon.

5 MR. NIXON: Good morning. I'm Dennis Nixon,  
6 President of International Bancshares Corporation. And I  
7 thank the Commission for the opportunity to participate  
8 today.

9 To respond directly to the topic of this panel, IBC  
10 firmly believes that short traders should be required to  
11 pre-borrow shares before engaging in a short trade, and  
12 should have parallel disclosure obligations to long traders.  
13 IBC has spent the last six months with a team of  
14 professionals educating, investigating, and taking action to  
15 prevent what appears to be manipulative short selling of IBC  
16 stock.

17 IBC has met personally with the Commission, ABA,  
18 FINRA, NASDAQ, and several members of Congress to explain the  
19 negative effect short sellers have on financial institutions.

20 Additionally, IBC submitted a 22-page comment  
21 letter dated June 9, 2009 on reinstating the uptick rule,  
22 which called for the Commission to vigorously enforce current  
23 short selling rules, institute a pre-borrow requirement for  
24 short sale transactions, promulgate disclosure rules for  
25 short sellers which mirror those obligations for long

1 positions, investigate the impact of the market maker  
2 exemption, and promulgate rules which would require brokers  
3 to allocate lent stocks and disclose the margin account -- to  
4 the margin account holder of the loss of voting for those  
5 shares.

6 In a supplemental comment letter dated June 17,  
7 2009, IBC urged the Commission to promulgate rules to address  
8 the lack of reporting and transparency in which short sellers  
9 operate. IBC has also submitted letters to bank regulators  
10 requesting their investigation into how short sellers may be  
11 violating certain banking laws.

12 All these efforts involve substantial expense of  
13 both time and money in an effort to better protect our  
14 shareholders, depositors, and the communities we serve. IBC  
15 is a well-capitalized \$11.4 billion multi-bank holding  
16 company headquartered in Laredo, Texas, serving 104  
17 communities in Texas and Oklahoma, and is traded on NASDAQ  
18 under the ticker symbol IBOC.

19 IBC is an award-winning bank and has been rated as  
20 one of the best performers among its peers. We have a record  
21 of over 136 consecutive quarters of continuous profitability.  
22 Having experienced economic downturns in the past, we  
23 expected an impact to our stock price, given the financial  
24 crisis. However, none of us expected that short sellers  
25 would be able to severely detach IBC's fundamental value from

1 its trading price.

2           Since the beginning of the year, IBC's short volume  
3 has increased to a record -- to a level of over 11 million  
4 shares, an increase of 891 percent. At its peak, short  
5 sellers represented over 21 percent of IBC's generally  
6 accepted float, and drove IBC's stock price from over \$24 to  
7 a low of \$6.55 in a matter of months.

8           We have provided two charts in our written  
9 statement filed with the Commission which show the dramatic  
10 impact that short sellers have had on IBC. IBC believes  
11 short sellers provide little value to the market outside of  
12 legitimate market-making activities.

13           The current rules allow for naked short selling of  
14 stock within the three-day window, but only classify the  
15 trade as naked once there is a failure to deliver. IBC  
16 believes a true naked short position is created when a short  
17 seller sells a stock without first borrowing the security.  
18 We have yet to be convinced why the current three-day  
19 delivery time should be allowed.

20           I want to thank you, and I look forward to  
21 discussing these issues with you today.

22           MR. BRIGAGLIANO: Thank you, Dennis.

23           Bill O'Brien.

24           MR. O'BRIEN: Good morning. I'd like to thank both  
25 the Commission and the staff for the opportunity today to

1 participate on behalf of Direct Edge, the nation's third  
2 largest stock market.

3           The Commission's targeting of naked short selling  
4 through the passage of stringent locate, borrow, and delivery  
5 requirements, such as Rule 204, have yielded impressive  
6 results to date by drastically reducing the incidents of  
7 failures to deliver, the data points of which I won't restate  
8 here. But the data clearly suggest the actions that the  
9 Commission has taken to date are working very well to curtail  
10 truly naked short selling.

11           Thus, at this juncture, the Commission's focus  
12 should be on what measures would be cost-effective in further  
13 curtailing abuse, while making the process of short sale  
14 delivery and settlement more efficient, and leveraging these  
15 efforts to rationalize the regulatory framework surrounding  
16 short sales generally.

17           Our belief is that imposing a pre-borrow  
18 requirement for short sales would constitute an inefficient  
19 use of capital, as such a requirement would need to be funded  
20 by prime and clearing brokers and would force securities to  
21 be locked up in a customer's account for the three days  
22 preceding settlement.

23           On the other hand, we believe that an examination  
24 of potential cost-effective improvements to the locate  
25 process are warranted, particularly if they can mitigate some

1 of the inefficiencies that exist in the current regulatory  
2 structure governing locates and improve coordination between  
3 custodians, executing brokers, market centers, and  
4 regulators.

5           Today, when a customer executes a short sale and  
6 custodies their assets at the same broker, whether it be a  
7 retail investor or an institution with the prime broker,  
8 generally the custodian will decrement shares available for  
9 lending thereafter on a real time basis as part of the short  
10 sale execution process. In such a scenario, a reliable hard  
11 locate is effectively obtained.

12           The challenge in broader mandates for hard locates  
13 would appear to be in achieving the same level of reliability  
14 for away locates, where the custodial and the executing  
15 broker are different, and provide similar certainty for  
16 actual delivery on a cost-effective basis.

17           Reliability could be enhanced by improving trade  
18 date validation for locates through end-of-day  
19 reconciliations between the locate broker and the executing  
20 broker. Such an approach potentially enhances the  
21 reliability of away locates, exposes naked short sellers, and  
22 facilitates inventory management of securities available for  
23 loan.

24           Initiatives and processes to facilitate this  
25 warrant further examination and support both with respect to

1 their efficacy and potential for expansion, such as the  
2 revised prime broker no-action letter.

3           Greater transparency for borrowing and lending  
4 transactions with proper audit and compliance standards also  
5 offer potential benefits of enhanced reliability. Further,  
6 such market developments can create an opportunity for  
7 integration of securities lending activity into the  
8 transaction process itself, alleviating systemic and  
9 regulatory risk.

10           Any regulatory initiatives, especially mandates,  
11 must heavily weigh their resultant costs. If properly  
12 constructed, regulation can make markets more efficient and  
13 allow for rationalization of certain short sale regulation.  
14 Any further regulation of the locate process needs to  
15 consider that current short sale regulation prompts over-  
16 location, that is, locating more shares than a market  
17 participant actually intends to short on a net basis.

18           Any inventory management efforts grounded in  
19 locates run the risk of restricting the availability and cost  
20 of locates, potentially disrupting even net long or market  
21 neutral trading strategies. Thus, any consideration of more  
22 stringent regulation will also need to consider how to  
23 alleviate some of the regulatory inefficiencies that will  
24 only be exacerbated by a closer correlation of located shares  
25 to shares sold short.

1           One potential tandem effort would be the extension  
2 of the buy-to-cover concept to all securities. Currently,  
3 Regulation SHO guidance requires a locate for each short sale  
4 of a hard-to-borrow security regardless of whether a market  
5 participant has covered such shares to repurchase between  
6 such shares on an intra day basis. That standard doesn't  
7 apply to easy-to-borrow securities.

8           In such a situation where a locate can be directly  
9 tied to actual shares used for delivery, there should be no  
10 distinction between hard-to-borrow and easy-to-borrow  
11 securities as the locate effectively assures to ensure  
12 delivery, regardless.

13           Additional further efforts to minimize the need for  
14 market participants to locate more securities than they  
15 actually will need to deliver for settlement, such as a broad  
16 reevaluation and potential expansion of the role of the  
17 market maker or similar exemptions in today's market  
18 structure, should also be examined.

19           There are many other markets where short sale  
20 regulation is based on net economic position as opposed to on  
21 a transaction-by-transaction basis, focusing on the  
22 sequencing of transactions.

23           With securities lending and short sale regulation  
24 coordinated more in this fashion, the likelihood of investor  
25 benefit from greater confidence and the more efficient market

1 will be optimized.

2           Once again, I'd like to thank the Commission for  
3 the opportunity, and I look forward to any questions.

4           MR. BRIGAGLIANO: Thank you, Bill.

5           Thomas Perna.

6           MR. PERNA: I'd like to thank the Commission for  
7 the opportunity to appear here today. Quadriserv is happy, I  
8 think, to have been included in the Commission's review of  
9 the securities lending process.

10           Our company holds a strong view on the need to  
11 continue to improve transparency and make settlement more  
12 efficient in the securities lending market. As we've seen  
13 with Rule 204, pursuit of this objective should involve  
14 targeted regulatory improvements and market-based solutions  
15 that enhance transparency and efficiency. We have and will  
16 continue to support efforts that advance those important  
17 objectives.

18           Those responsible for implementing any proposals  
19 certainly would face challenges that should be carefully  
20 considered. However, many participants in the securities  
21 lending process have expressed a desire to move beyond the  
22 reasonable determination locate structure.

23           The mandatory pre-borrow requirement, although  
24 having a benefit of zero sum inventory accounting between  
25 shares located and shares borrowed is balance sheet intensive



1 and would significantly raise the net cost of borrowing  
2 stock. We believe that the unintended consequences brought  
3 on by these additional costs would certainly far outweigh the  
4 benefits.

5           In the interest, though, of evolving towards the  
6 most efficient, reliable market possible, we hope to see a  
7 middle ground. We believe that a logical middle ground could  
8 be developed. We could develop an auditable capital  
9 operationally efficient marketplace for locate supply and  
10 demand to interact.

11           We believe there are technological and operational  
12 frameworks that exist and can be further developed to achieve  
13 that objective. A centralized settlement or inventory  
14 accounting system could serve to further reduce settlement  
15 friction and contribute towards the industry's collective  
16 goal of making markets more efficient for investors.

17           With that said, we're very cognizant of the complex  
18 challenges that face the broker dealer community, in  
19 particular with many of the proposed hard locate proposal  
20 standards. With the adoption of Rule 204 as a guiding  
21 indicator of success, we're confident in the industry's  
22 ability to arrive at a compromise solution that works for  
23 those on both sides of the debate.

24           If a common belief emerges on the need for  
25 incremental steps to be taken to address the last mile

1 challenges of settlement date efficiency in the market, those  
2 steps should allow for the supply and the demand dynamics of  
3 a market where there is both a cost and a benefit to  
4 satisfying locate requirements, and something that's easily  
5 auditable.

6 This would allow for a market-based resolution to a  
7 challenge where there are incentives for participants to  
8 participate in a solution. Thank you.

9 MR. BRIGAGLIANO: Thank you, Tom, and thank you,  
10 all the panelists, for your thoughtful statements.

11 Are there questions from the Chairman or  
12 Commissioners?

13 CHAIRMAN SCHAPIRO: Thanks, Jamie. I have a couple  
14 that I could start us off with.

15 I'm interested -- I think Bill and Michael had a  
16 number of suggestions for improving the existing locate rule.  
17 I wondered if others of you had further thoughts on that -- I  
18 guess something short of a hard locate, but tweaks to the  
19 existing rule that would improve it.

20 And I guess let me add to that. I'd also love to  
21 know, as a second matter, what are the differences in costs  
22 between the current locate rule, if everybody's following it,  
23 and a hard locate rule? Is there really a significant  
24 increase in costs if we go to a hard locate?

25 MR. DRISCOLL: Well, the STA has mentioned several

1 times already that we have concerns about the reasonable  
2 standard in Rule 203, and we think that that needs to be  
3 tightened up.

4 We also have concerns whether the industry is  
5 complying with the requirement to locate whether or not  
6 you're going to cover that short within the same day. We  
7 think that those two areas could bring some considerable  
8 improvement in the way the locate rule works now.

9 MR. MENDELSON: I would also like to say that I've  
10 heard many different hard locate proposals. There are some  
11 that are used in Hong Kong. There's a proposal that's  
12 floated around the industry a little bit that I think has not  
13 been very well received. There's a few other proposals in  
14 between.

15 And I think the cost is -- I think the cost is  
16 pretty high for all of them to investors, but it does vary.  
17 Proposals that -- you know, there was one particular proposal  
18 that is a little bit of a Rube Goldberg device, where we end  
19 up having to make so many different steps of communication  
20 before doing a trade, after doing a trade, that it would  
21 really throw a lot of sand in the gears of trading.

22 I think that there are other proposals that are  
23 much less onerous. They still, I think, have some basic  
24 economic problems. But the costs do vary quite a bit.

25 CHAIRMAN SCHAPIRO: Are the costs -- this is an

1 industry that is so talented when it comes to technology, and  
2 so creative and so capable of solving problems with  
3 technology. So are the costs in the creating the solution to  
4 have a hard locate, or are the costs in having a hard locate,  
5 period?

6 MR. MENDELSON: I think there are a lot of the  
7 costs that are just about having a hard locate that are  
8 economic. I think there are other parts that are technology,  
9 and that yeah, you know, with some expense, the industry can  
10 find a way to evolve, although it will have an effect.

11 There is not going to be a low latency way of  
12 communicating between all these different organizations that  
13 will satisfy all the liquidity demands of the market.  
14 Nevertheless, irrespective of those costs, if we faced all  
15 those costs, there are still going to be costs to our  
16 investors in the form of additional costs of short selling;  
17 and as a long -- in our purchases of stock, it will also cost  
18 us more because market-making activity will decline.

19 MR. LYNCH: I think part of the answer is how  
20 perfected do you want the hard locate to be? So at a general  
21 high level, obviously there will be a cost of technology and  
22 all of the documentation and administration around the hard  
23 locate.

24 But then if you want an extremely perfected hard  
25 locate, so much so that you're actually encumbering shares

1 somewhere for that hard locate, well, then, there's going to  
2 be an actual cost of encumbering those shares.

3           Whether you call it all the way to the point of a  
4 pre-borrow and a physical delivery, or whether you just call  
5 it that shares are set aside within the prime broker or set  
6 aside within an agent lender for the potential for that short  
7 sale to go through, well, there's going to be a cost with  
8 encumbering those shares.

9           COMMISSIONER WALTER: But isn't part of the problem  
10 today -- let me pick up on cost. Isn't part of the problem  
11 today -- the way it works is statistical, and yet there's no  
12 cost to developing, at least theoretically, a reasonable  
13 ground to believe that you can locate the shares.

14           There are no dollars that change hands, which gives  
15 a perverse incentive to go out there and cover whatever your  
16 potential activity might be, which undermines the statistical  
17 analysis.

18           So I'm sort of surprised that the industry hasn't  
19 come up with a solution, particularly as this controversy has  
20 continued to swirl and does not go away, that realigns by  
21 imposing a cost on locates, at least for hard-to-borrow  
22 securities, that would keep that from happening.

23           And I would add to that that the fact that there  
24 isn't a cost transfers the cost, in effect, to our  
25 enforcement program and leaves us with a problem in terms of

1 trying to determine whether people in fact have reasonable  
2 grounds to believe that they can locate the securities, which  
3 is a very difficult case to bring, and is not the place where  
4 you want the cost to be.

5 So I'd love to get your reactions to that.

6 MR. DRISCOLL: Well, we certainly believe that  
7 there has to be some rationalization of the shares located  
8 with the shares available. How that's done, it could get a  
9 little tricky. But somewhere along the line, the practice of  
10 going out in the morning and trying to borrow a million  
11 shares of every S&P 500 stock -- somewhere along the line,  
12 that stuff has end.

13 COMMISSIONER WALTER: And so what's the way to do  
14 it, as a pragmatic matter that works? I mean, might it be  
15 possible, for example, to use the fail list, and as soon as a  
16 security, for example, appears on that, to impose a hard  
17 locate requirement then?

18 You know, the industry has been grappling with this  
19 for a long time and doesn't want regulation. Yet I don't  
20 think we've seen any movement to really cure this problem.  
21 And there isn't anything to stop everybody from going out and  
22 borrowing a million shares of the entire, you know, Russell  
23 3000 every morning.

24 MR. DRISCOLL: We did suggest that the circuit  
25 breaker hard borrow would work along that line. We think it

1 would be effective and targeted, and we would go along with a  
2 proposal like that.

3 MR. CONLEY: Well, I'd just add a couple of  
4 comments to that. The first thing is a hard locate is not a  
5 guarantee of delivery. We should really delineate the two of  
6 these because if we go to a bank, in this case State Street  
7 since they're on the panel, and say, we'd like to get a hard  
8 locate on this security, their client can still sell the  
9 security.

10 So the hard locates are done on trade date. Their  
11 client can sell on trade date simultaneously, which will be  
12 reported to them in the evening on trade date. That stock  
13 will be delivered for the client's sale rather than lent to  
14 the prime broker or short seller for delivery.

15 So I think, as we're contemplating this, that's  
16 just a fundamental tenet that we need to understand. And if  
17 we do restrict or encumber those shares, essentially what  
18 we're telling the investors is they can't sell those shares  
19 going forward because those are secured for a securities loan  
20 transaction. And I don't think that the Commission would  
21 want to -- would want to go down that line as well.

22 COMMISSIONER WALTER: But there's a difference, I  
23 think, between taking the risk that the shares will be sold  
24 and taking the risk that those same shares, in effect, have  
25 been located by, you know, a hundred different people. And I

1 think focusing on the sale risk is only a minor part of the  
2 issue. And maybe that's a risk that we ought to be willing  
3 to live with, but not the other.

4 MR. O'BRIEN: I think you have to recognize that  
5 only does the reasonable grounds standard, you know, prompt  
6 over-location. But a lot of other aspects of short sale  
7 regulation do, you know, as well.

8 I mean, even, you know, the recent change to FAQ  
9 2.5 where, you know, all sale orders have to be marked short,  
10 assuming that they're all going to be executed, but  
11 outstanding buy orders at the same time don't -- there's a  
12 lot of aspects of current regulation that prompt market  
13 participants that are not really true short sellers in the  
14 fundamental economic sense to have to locate a lot of stock.

15 And I think it's a question of mandates, too,  
16 versus motivation. There may be products out there where you  
17 can, you know, tie back the shares more effectively. And  
18 maybe there's disparate regulatory treatment under the short  
19 sale rules to prompt that.

20 And then people can make their own economic  
21 decision of whether that transaction flexibility, you know,  
22 warrants the economic cost of using a hard locate or similar  
23 system.

24 COMMISSIONER WALTER: But what if -- can I come  
25 back to my initial thought and get a reaction to that, which



1 is, what if there were a cost imposed on the location  
2 process? How would that -- how would you think that that  
3 would change behavior?

4 MR. MENDELSON: Well, I think we should start by  
5 thinking about why do we over-locate, which is a concern you  
6 have. We over-locate because when we have to do the locates,  
7 we don't know what we're actually going to short that day.  
8 So all of us, speaking for my firm as well as other large  
9 investors, we may at the beginning of the day say, well, I  
10 don't know how much Exxon we may short today, but it might be  
11 as many as 50,000 shares, so I'll locate 50,000 shares.

12 We won't, for sure, all of us, sell short the  
13 maximum we could. We have that locate request out there  
14 because the market opportunity may exist for us to short sell  
15 those securities. It won't exist if everyone else who's  
16 over-located the stock has sold short that stock.

17 And so the result is that the statistical issue  
18 which you raise -- and you're right, the system does work  
19 today on a statistical basis -- that there is such a low  
20 probability that those locates that the prime brokers give us  
21 will not in fact be delivered on.

22 COMMISSIONER WALTER: Understood. But I'm trying  
23 to change the scenario for you and say, if there were a fee  
24 charged, and not an outrageous fee, a fee charged for the  
25 location process, how would people's behavior change?

1           MR. MENDELSON: Well, you would locate less for  
2 sure. Okay. I mean, that would be the obvious result of it.  
3 But I think what would happen is you would impose a cost on  
4 investors that would really end up impairing liquidity.

5           All you would be doing is -- right now we have a  
6 system that does work pretty well for this. We have  
7 suggested some improvements to it, but it works pretty well.  
8 You'll start imposing additional new costs on our investors  
9 that will widen bid/ask spreads. It'll be the first thing  
10 you'll see.

11          DR. HATHEWAY: Let me take a different tack a  
12 little bit on Mike's answer, if I can.

13          We don't know who the sort of marginal user of a  
14 locate is right now because there's no price. It might be a  
15 liquidity provider. It might be an arbitrageur. It might be  
16 someone taking a large, speculative short position, or even  
17 launching an abusive attack on a company.

18          My guess is it's not that last guy. So unless we  
19 can put -- somehow figure out who should pay what price,  
20 putting a constant price on a locate is going to be a very  
21 difficult thing to do.

22          And frankly, it may create, even within a subset of  
23 the community -- say, the liquidity providers -- it may  
24 create advantages for large firms who can or will locate in  
25 scale and use the locate to the detriment of smaller firms,

1 or some other dimension of it. One size fits all pricing, I  
2 think as you understand, would be a challenge.

3 MR. LYNCH: I'd like to go back to your initial  
4 point, which was that if you targeted the 0.1 percent fail  
5 list and then you strategically placed that list within a  
6 potential structure, whether that's a pre-borrow or a hard  
7 locate, that's a much more strategic regulation to find where  
8 the potential abuse is, as opposed to put it across the  
9 entire industry.

10 MR. HODASH: Could I have one point of  
11 clarification? The hard locate proposals, I think the  
12 questioning has uncovered there is no single hard locate  
13 proposal; that perhaps transparency into the process and  
14 understanding which securities, which market segments, are  
15 over-locating, if it's happening, might be a prudent first  
16 step.

17 So even in discussing that, the hard locate  
18 proposal that we've been discussing with clients, there are  
19 costs associated with that. But there's less of a latency  
20 issue involved in post-trade transparency reporting type  
21 solutions in order to understand what's going on, and  
22 sometimes that changes behavior itself.

23 That said, there's still technical issues with that  
24 concept as well.

25 MR. CONLEY: I think, ultimately, the objective

1 here is to reduce down fails and eliminate abusive short  
2 selling. And I think the way that you do thought is you link  
3 the order marking and communication between the client, prime  
4 broker, and the executing broker.

5           And the executing broker is then mandated to use  
6 any information of discrepancy, contemplating forward trades  
7 with customers. I think that's really connecting the circle  
8 of all the different parties in these transactions. I think  
9 that's really the solution.

10           And then potentially with some regulatory output of  
11 the discrepancies that aren't resolved between prime broker  
12 and customer, I think it will give the regulatory authorities  
13 clear visibility on if people are circumventing the locate  
14 rules.

15           MR. NIXON: Yes. Just to comment, I think, you  
16 know, from the Main Street side of this, I think there's a  
17 lot more involved here than just this locate rule because I  
18 believe this whole side of the market, frankly, is out of  
19 balance.

20           And we've seen a tremendous damage to our company  
21 of 30 years of productive work being fundamentally destroyed  
22 by a predator practice that came against us in a bear market,  
23 when all financial institutions are in chaos, you know. And  
24 for somebody in our case to be able to go out and issue  
25 11 million new shares of our stock without any kind of

1 registration process or any kind of formal process is just  
2 unbelievable to us.

3           And on the long side of the market, when you're  
4 going to -- if John Doe America wants to sell a share of  
5 stock, he's got to put it in his broker's account. He's got  
6 to go through the process to put it in a nominee name before  
7 anybody will even accept the sale of that stock.

8           So it seems somewhat ridiculous to me that we're  
9 talking about the short guy who can, just like a cowboy here,  
10 go do anything he wants to; but on the long side of the  
11 market, you have all this extreme restrictions. And it puts  
12 us at a disadvantage on the long side because we're trying to  
13 build an investment here.

14           Are we worried about the short sellers or are we  
15 worried about the investment community? And Mr. and  
16 Mrs. Mainstream America, in my view, is being abused. We  
17 lost \$1,200,000,000 worth of value in our company in about  
18 45 days.

19           And I think it was all attributed to this predator-  
20 type short selling that goes on in this market today that's  
21 uncontrolled. It's unbelievable. And if you live through  
22 this in a mainstream fashion, then you understand this.

23           We're talking about a bunch of guys here making  
24 money off of Main Street. We're transferring -- we  
25 transferred that \$1.2 billion from Main Street to Wall

1 Street. And it doesn't seem anybody's concerned about it.  
2 And I think that's what the Commission should be concerned  
3 about. How do we protect Mom and Pop Investor out there  
4 versus enabling a bunch of guys who are really speculating on  
5 the demise of companies, not the growth of companies?

6 MR. DRISCOLL: While I have great sympathy for the  
7 predicament of certain stocks that are targeted, I think that  
8 you have to remember that the vast majority of short sellers  
9 are legitimate people using hedge positions.

10 I think that you have to target the unacceptable  
11 behavior, root out the manipulation, and go after that. You  
12 can't just expel the whole class because of one disruptive  
13 student.

14 MR. HODASH: And to stay on your question,  
15 Commissioner Walter, \$1.2 billion on the table, you can't  
16 price a locate high enough. So we're really looking at  
17 another type of solution, either a transparency one that  
18 facilitates the enforcement process, or a different mechanism  
19 other than sort of the price mechanism for either the locate  
20 or the pre-borrow.

21 Because if you're focusing on a concentrated attack  
22 on the company and the costs, the price of doing it, is based  
23 on sort of the average price of a short sale across the  
24 market, you've got a big disconnect between what you intend  
25 to gain from an abusive attack and what it's going to cost

1 you to do it in a locate or a pre-borrow.

2 COMMISSIONER WALTER: The other thing that we  
3 potentially could do is to put harder edges around the  
4 reasonable belief requirement, and put more objective edges.  
5 Now, there are going to be costs to that as well. But when  
6 you've got a standard like that, you have to expect that the  
7 enforcement efforts are going to be difficult.

8 MR. O'BRIEN: And I think you go back to validation  
9 as well because unlike a regular transaction, where the  
10 broker that's executing it and the broker that actually is  
11 going to make delivery and settlement are the same in a short  
12 transaction where there's an away locate, you have the  
13 possibility for the left hand not to know what the right hand  
14 is doing in terms of what's the reasonable grounds for an  
15 executing broker to say that they've made that determination  
16 that effectively, the prime or other custodial broker is  
17 going to ultimately have to back up, you know, with  
18 settlement.

19 And so the validation point, I think, echoes true,  
20 and having a regulatory output to that to make the cost of  
21 enforcement, you know, much more -- much more efficient,  
22 potentially.

23 MR. BRIGAGLIANO: I'd like to jump in here on the  
24 issue of away locates because I think there is an important  
25 point. Currently, the broker does have the requirement to

1 locate, but the broker may also rely on an assurance from a  
2 customer. And that customer is not necessarily a regulated  
3 entity.

4           So I'd like to get the panelists' reaction to this  
5 situation, the costs and benefits of continuing with the  
6 broker dealer requirement to do the locate, but not allowing  
7 the broker to rely on a customer and putting it all on the  
8 broker, so to speak.

9           MR. DRISCOLL: Well, that interpretation came from  
10 a footnote in a Frequently Asked Question release. And we  
11 have great problems with the broker dealer being allowed to  
12 rely on his customer, especially the unregulated entity.

13           It seems that as the hedge fund community has  
14 grown, they've become a huge part of the revenue stream that  
15 a broker dealer gets. And we kind of believe that the broker  
16 dealer would be very readily acceptable to any offer of  
17 assurance that the hedge fund would give them. We don't  
18 think that that's a reasonable standard.

19           MR. PERNA: You know, I think, going back to some  
20 of the earlier comments, I think, you know, we believe that,  
21 you know, there can be a market, a central market; whereas I  
22 think I said in my opening comments the locate requirements  
23 and locate shares could meet.

24           I think, you know, the pool, a centralized pool, I  
25 think would deal with some of the issues around customers



1 pulling back, between trade date and a settlement date, those  
2 shares. There could be -- there certainly would be a  
3 minimal, you know, cost, you know, imposed there during that  
4 time, which certainly could, you know, inure to the benefit  
5 of the beneficial owner of the shares.

6 But I think that's certainly, you know, one listing  
7 to all the issues, which certainly are true. I think that  
8 central pool of available locate shares, you know, I think is  
9 something that certainly should be considered, and I think is  
10 doable.

11 MR. CONLEY: While we talked about Rule 204 several  
12 times in the beginning, I'd just like to reemphasize the  
13 policing nature of this because if somebody -- if a customer,  
14 you know, misrepresents a locate, for example, the trade is  
15 going to get closed out on trade date plus four.

16 So after settlement date, the trade will fail, and  
17 then the trade will be closed out through the buy-in process.  
18 So the rulemaking, as it stands currently, protects against  
19 abusive behavior in that particular sort.

20 And one other comment on the statistical nature of  
21 the locates, referencing back to 204. If you are wrong on  
22 the locate, you will get closed out. And that's a painful  
23 experience, to get forcibly closed out of a position.

24 So I think that most professional players in the  
25 market, as well as the prime brokers, are very cautious about

1 how they're locating inventory. You know, we go through  
2 great lengths to collect lots of different inventory feeds  
3 from lenders in the market and haircut those through  
4 statistical provisions to understand what we believe is the  
5 reliable nature of that because if we're wrong, we forcibly  
6 have to close out our customer.

7 MR. BRIGAGLIANO: Bill, I'd like to follow up a  
8 little bit because there's a point that Dennis raised that  
9 others occasionally raise, and I think it's worth bringing to  
10 the panel's attention.

11 204, as has been noted, has had dramatic results in  
12 reducing fails. But some say that even though the broker has  
13 to close out, you know, on T4, that still allows a window for  
14 a customer to, you know, commit naked short selling.

15 I'd like your reaction to that.

16 MR. CONLEY: I think my reaction is -- back to my  
17 earlier comments about moving forward with the prime  
18 brokerage no-action letter because that effectively connects  
19 the prime broker, customer, and executing broker on trade  
20 date plus one. That to me seems like the most rational way  
21 to control for behavior and to eliminate any type of  
22 activity, taking advantage of the normal settlements, like on  
23 the United States right now.

24 Short of that, I mean, I don't think the Commission  
25 is prepared to do this, but to consider changing the

1 settlement period, the standard settlement period, for short  
2 sales versus long sales. I know there's been a lot of  
3 historical work looking at shortening settlement cycles in  
4 the U.S., and I don't think that that's an issue on the table  
5 today.

6 COMMISSIONER PAREDES: If we can take just a little  
7 bit of a step back. We're talking a lot -- and I think  
8 appropriately so, and the discussion is fascinating -- about  
9 solutions. But just to take a step back to make sure we're  
10 all on the same page, or at least get the sense of folks, as  
11 to the problem.

12 And there I guess my specific question is: When  
13 you think about fails, to help us better understand from you  
14 perspective, what are the potential causes of a fail? And so  
15 often we're talking about naked short selling. We're talking  
16 about the failure to deliver. We're talking about abuses.  
17 We're talking about manipulation. And yet there may be  
18 reasons other than manipulation, that there is, in fact, a  
19 fail.

20 And without assessing that and trying to dissect  
21 the potential causes in a little more refined way, we may get  
22 off course in terms of some of the suggested solutions.

23 So I'll start with Bill, and Bill, to give a couple  
24 of different perspectives -- but we'd be delighted to hear  
25 from folks along the way on their thoughts.

1           MR. CONLEY: Thank you. You're absolutely right.  
2 I think we are focusing a lot on manipulative activity here  
3 and not looking at the broad basket.

4           Our most recent review of fail data shows that, I  
5 think, more 50 percent of the fails are ETFs right now, which  
6 are broad baskets of securities. And we believe that that's  
7 a functional result of the latency between the create and  
8 redeem process, between the issuers and the underlying  
9 baskets.

10           Additionally, a large percent of the fails  
11 currently in the market are penny stocks, so positions less  
12 than a dollar. And there are issues -- I can refer to Bill  
13 Hodash on this -- but some securities get chilled and just  
14 don't move through the security system. So if they're in  
15 transit during the chilling process, they're not going to  
16 move.

17           So I think if we were to undertake some effort from  
18 this meeting today, I think one of the things would be to  
19 understand and make public what really are the issues that  
20 are failing. And I know that you're doing this on the  
21 website, and we pull the information down and look at it.

22           But I do think that investors will find that it's  
23 ETFs and a lot of penny stocks are really the two themes that  
24 we've observed there.

25           MR. DRISCOLL: When I did do my analysis of the

1 63 stocks that I mentioned that were on a threshold list, the  
2 day that I looked at it, five of them were actual operating  
3 companies, and the other 58 were ETFs.

4 COMMISSIONER WALTER: Do people have any  
5 suggestion, given the prevalence of ETFs on the fail list, as  
6 to what could be done to eliminate or at least minimize that  
7 problem? Because I think we would all agree that the optimal  
8 result is for the fail list to have nothing on it.

9 Now, that may be an impossible dream, but we ought  
10 to try to get as close as we can. And given the structural  
11 difference with ETFs, is there a different way to approach  
12 them? Do we need a targeted solution?

13 CHAIRMAN SCHAPIRO: And can I add a question to  
14 that, given that penny stocks seem to be the other prevalent  
15 presence on the fail-to-deliver list? Is there any reason to  
16 think about them differently and to have a different set of  
17 requirements around penny stock locate or pre-borrow, as  
18 opposed to companies over a certain size?

19 MR. HODASH: Since nobody's jumped on the two  
20 recent questions, I'm going to go back to Commissioner  
21 Walter's.

22 Fails are an issue. Large short positions,  
23 particularly when the short position is of a magnitude that  
24 can't readily be explained by the shares that are available  
25 to lend, are a problem that we hear from our issuers, and I'm

1 sure other exchanges do likewise.

2           While I've never had anyone on the regulatory side,  
3 either of the Commission or Commission staff or FINRA, say  
4 they can't bring an enforcement action, I have heard people  
5 say that it is difficult to bring enforcement actions around  
6 short selling, around locate, around the rules that predated  
7 204.

8           I haven't had a conversation since 204, but given  
9 the arguments I heard, I would suspect that it's the same  
10 today. And I think one avenue for the Commission to pursue  
11 is improving the audit trail and the paper trail around the  
12 short selling process so when we have a short position that  
13 it's hard to understand and it's hard to understand how fails  
14 are avoided, there's a better documentation on, frankly, how  
15 the short sales were accomplished.

16           MR. LYNCH: I think the two characteristics of  
17 those two types of securities, the penny stocks and the ETFs,  
18 that are -- that kind of tie it together is both of those  
19 types of securities in the long-only beneficial owners  
20 portfolio are something that are actively traded in and  
21 out of.

22           So if you're in penny stocks, there's a good chance  
23 that you're potentially liquidating at some point in time.  
24 Something brought it to that point. If you're -- if you're  
25 sitting in ETFs, you're getting in and out of that exposure,

1 from a basket perspective, at the client level.

2           So that creates a lot of volatility to the prime  
3 broker as of what supply is there on a day-to-day basis to  
4 cover the shorts. And that volatility potentially puts you  
5 into a fail situation at times.

6           MR. HODASH: Just one clarification on the ETFs.  
7 The figure is -- in July 2009, it was about 43 percent of the  
8 fails that I reported were in ETFs. And though I don't have  
9 the figure precisely a year before, although I cited  
10 statistics to show that the overall fail rate dropped  
11 precipitously during that period, the proportion of fails in  
12 July 2008 that were ETFs were smaller.

13           So there may be, to your point about studying the  
14 redemption, the create redemption process, something  
15 structural to be looked at because they did not drop by near  
16 the same amount as the non-ETFs dropped in that time.

17           COMMISSIONER WALTER: Does it also suggest that the  
18 statistical analysis that is engaged in in the marketplace  
19 for those two types of securities needs to be re-looked at?  
20 Since there is a tilt in that direction and it happens that  
21 much more often, if we all agree that that result is not what  
22 we want, perhaps the statistical analysis needs to be  
23 tightened up.

24           MR. MENDELSON: Well, it may be possible that the  
25 rise in the share of ETF fails is because of the decrease of

1 everything else.

2 COMMISSIONER WALTER: Oh, it clearly is. But  
3 we're -- I mean, at least in part that's what it is. But  
4 nonetheless, if you'll assume with me for a moment -- and  
5 maybe you don't agree with this, which you should feel free  
6 to state as well -- that having the number of ETFs and penny  
7 stocks on this list that we do is not what we want, and given  
8 the prevalence, it suggests to me that the statistical  
9 analysis is working better for other types of stocks than for  
10 this.

11 MR. MENDELSON: Well, I think, at least in my, you  
12 know, discussions I've had over time with participants in  
13 this market, I think one of the surprising things is that the  
14 understanding of the source of the fails is not as good as  
15 you would expect.

16 And so in understanding, let's say, the problem  
17 with ETFs, chilled stocks, other, you know, real operating  
18 companies, of which there are really only a few on the list,  
19 and to understand why some operating customers are  
20 persistently on the list and some only pop up occasionally, I  
21 think we really need to have a better understanding of this.

22 Because I think one of the reasons that we're all  
23 here today is because of fears that certain people have -- I  
24 do not share those fears, but fears that some people have.  
25 They look at a list, and without dissecting what the source



1 of those fails are, they attribute it to behavior that is  
2 probably not in fact happening. Okay?

3           And I think if we better understood the sources of  
4 those fails through additional requirements on the executing  
5 and prime brokers, or executing and clearing brokers, to  
6 gather the data and examine statistically the source of the  
7 fails, I think that we would have a much better understanding  
8 of the problem.

9           COMMISSIONER WALTER: Do people in today's  
10 marketplace take into account the nature of the person, the  
11 identity of the person, who is asking for the locate? I  
12 mean, is that part of the analysis?

13           If you've been doing business with somebody who  
14 persistently, you know, never sells short after the locate,  
15 does that -- I would assume that, again, given the last of  
16 cost, there's no reason for anybody to take that into  
17 account.

18           MR. CONLEY: The overriding factor on locates is a  
19 function of availability. I think it's less a function of  
20 customer behavior, and really our ability to be able to  
21 deliver the stock at the point of delivery.

22           MR. NIXON: Can I make one additional comment?  
23 Listening to all these experts on Wall Street, I still don't  
24 understand why the short side of the market is allowed to  
25 issue shares at random, at will, at whim, without any kind of

1 registration restrictions at all.

2 In my case, in our company, we have a certain  
3 number of registered shares, and we've had to go through an  
4 exhaustive process through your agency to get those shares  
5 registered. We have to file proxy statements. We have to  
6 file annual reports.

7 But somebody, at a whim, can go out and issue  
8 11 million of my shares in 45 days without any of those  
9 requirements. And so I just don't understand -- I understand  
10 all this discussion of locate and borrowed shares and all  
11 that. But I don't understand the underlying principle of why  
12 the long side of the market has such tremendous restrictions  
13 and barriers, but the short side of the market is the Wild,  
14 Wild West.

15 MR. MENDELSON: I guess my response would be that  
16 when there's naked short selling, which again is a practice I  
17 don't think any of us are proponents of, then that does have  
18 potentially the effect that you describe.

19 But covered short selling, where we borrow  
20 securities, does not have that effect. There's only one  
21 person who can vote a share, and that is the point, I think,  
22 of why we locate and borrow and deliver securities. And  
23 that's what's at issue here today.

24 But if that's done properly, I think the problem  
25 that Mr. Nixon is raising does not exist.

1           MR. NIXON: I disagree with that because we've seen  
2 a pattern of over-voting. But I still get down to the fact  
3 that if I have to issue -- if I want to issue 11 million more  
4 shares of my stock on the long side, I've got to go through a  
5 very diligent process, and a very exhaustive process, to do  
6 that.

7           And under the short side of the market, they simply  
8 have expanded my shares to another 11 million shares. And  
9 they've imposed them on a market situation on a short period  
10 of time where there's no effort being planned on the positive  
11 side of the market to acquire -- to ensure any kind of  
12 orthodox issuance.

13           Most people, when they go out and have a new stock  
14 issuance, have road shows, promote the value of the company,  
15 all of those positive aspects in issuing shares. And I have  
16 had a stock that's traded in the range of a couple of hundred  
17 thousand shares a day -- some people have joked that my  
18 shares trade by appointment -- and suddenly I'm trading at a  
19 million five and two million shares a day, and somebody in a  
20 short period of time dumps 11 million shares of stock on the  
21 market.

22           There is no way in the world that that stock can be  
23 defended against loss. I can't come out and make positive  
24 statements about my company because those would be forward-  
25 looking comments and I'd be slapped down for that.

1                   But the short side can create all kinds of  
2 speculative comments and issue negative reports and draw  
3 questions against the company. And in the bear market which  
4 we've just recently experienced, there's almost no defensible  
5 position that a positive side of the market has. Nobody  
6 wants to listen to good news. They only want to listen to  
7 bad news.

8                   So there's no defensible position on the long side.  
9 And so when the Commission is looking at this, I think it's  
10 important that we look at these technical and strategic  
11 issues, like we're dealing with today. But the big picture  
12 here is why should this go on?

13                   Well, I can tell you why it goes on: because these  
14 guys make a lot of money out of lending stocks. I'm in the  
15 lending business. But I don't understand why we have an  
16 unequal playing field here. If you want me to compete, well,  
17 I'll compete. But I don't want to compete against a field  
18 that has a strategic advantage against me.

19                   MR. DRISCOLL: As Mike --

20                   MR. NIXON: And we've spent -- we've spent 30 years  
21 building value, which was destroyed in 45 days.

22                   MR. DRISCOLL: As Mike said, legitimate short  
23 sellers go out and borrow the stock. And just to remind  
24 people that the beneficial owner of that stock can refuse to  
25 have it lent and restrict the short selling even more.

1           But legitimate short sellers are not creating  
2 phantom shares. They're actually going out and buying the  
3 stock -- or borrowing the stock.

4           MR. NIXON: And that's -- I would respond that  
5 that's also an interesting issue, too, because half of -- or  
6 two-thirds of the people who have their stock in margin  
7 accounts don't even know that the stock is being lent. You  
8 know, most people -- you ask the average guy on the street,  
9 is your stock being lent? They don't have an idea. They  
10 have no idea that that's going on.

11           Most of this is -- and I call this the Darth Vader  
12 side of the market, you know. And it's really not a very  
13 pleasant side of the market.

14           DR. HATHEWAY: We certainly have increased  
15 disclosure under the guidance of the Commission on short  
16 trading and now the aggregate short selling on a daily basis.  
17 And NASDAQ has long been in favor of the equivalent of a 13F  
18 disclosure for short positions as akin to what exists on the  
19 long side.

20           It's sort of an interesting concept on a disclosure  
21 document from a large short seller. I don't -- yeah. The  
22 long side doesn't have to reveal investment strategy. Should  
23 there be a different obligation on the short side to explain,  
24 you know, what they're doing and disclose? It would be a  
25 change for you all. But it's an interesting thought.

1           MR. LYNCH: And without getting into the kind of  
2 disclosure of what should happen in relation to long versus  
3 short, it's just important to have the underlying premise  
4 that legitimate short selling is very important in the  
5 marketplace. It creates a positive conflict as securities go  
6 up in value. It creates a positive conflict as securities go  
7 down in value. And it stops the ability of falling off the  
8 cliff with only sellers in the marketplace at a given time.

9           So for an efficient marketplace, short selling is  
10 an extremely important part of it.

11          MR. BRIGAGLIANO: Well, that's a perfect place to  
12 end our first panel. I'd like to thank all the panelists for  
13 their thoughtful and candid insights. And we even got a good  
14 segue and preview of our next panel, which will be all about  
15 disclosure and transparency of short selling, and will  
16 promptly begin at 11:10. Thank you.

17          (A brief recess was taken.)

18          MR. BRIGAGLIANO: Today's second panel is entitled  
19 "Making Short Sale Disclosure More Meaningful: Public versus  
20 Non-Public Reporting; Consolidated Tape Disclosure;  
21 Timeliness of Information." I will be moderating this panel  
22 along with my colleagues John Polise, Assistant Director in  
23 the Division of Enforcement, and Brian Breheny, Deputy  
24 Director of the Division of Corporation Finance. Following  
25 introductions, the panelists will each make a brief opening

1 statement. Again, because we have a lot of information to  
2 cover in a relatively short amount of time, we ask that  
3 panelists limit their opening statements to no more than  
4 three minutes.

5 As with our first panel, following opening  
6 statements, the panel will receive questions from the  
7 Chairman and Commissioners. Again, we encourage the  
8 panelists to engage in dialogue with one another so that we  
9 can have a lively and informative discussion.

10 Before we begin, let me welcome and introduce our  
11 distinguished panel.

12 Dr. Jim Angel is an Associate Professor at the  
13 McDonough School of Business of Georgetown University.

14 David Carruthers is the Head of Quantitative  
15 Strategy at Data Explorers.

16 Richard Gates co-founded TFS Capital, and serves as  
17 a Co-Portfolio Manager at the firm.

18 Michael Gitlin is a Vice President of T. Rowe Price  
19 Group, Inc., and T. Rowe Price Associates, Inc.

20 Jesse Greene is Vice President of Financial  
21 Management and Chief Financial Risk Officer of IBM.

22 Joseph Mecane is Executive Vice President and Chief  
23 Administrative Officer for U.S. markets at NYSE Euronext.

24 And Michael Treip is Technical Specialist in the  
25 Market Infrastructure and Policy Department of the U.K.

1 Financial Services Authority.

2 Dr. Angel, would you like to start us off with your  
3 opening statement, please?

4 DR. ANGEL: Thank you. Good morning. It's an  
5 honor to be here.

6 When we talk about transparency, there's one thing  
7 we must not forget. When we mandate transparency, we are  
8 imposing a compliance tax on the industry and an enforcement  
9 burden on the regulator.

10 Furthermore, we are confiscating intellectual  
11 property and breaching financial privacy. In order to do  
12 that, there had better be a compelling public purpose. And I  
13 believe, around short selling, there is a compelling public  
14 purpose that more than meets this very high burden.

15 For one thing, better transparency will promote  
16 market integrity. Whenever stocks go down, the short sellers  
17 get blamed. You know, there are allegations of unsavory  
18 activity, sometimes founded, often not. With better  
19 transparency, the markets can see for themselves whether  
20 indeed there is abusive short selling or not.

21 The second compelling reason is that of market  
22 efficiency, especially in the stock lending business. One of  
23 the problems with trading is what I call the prisoner's  
24 dilemma of trading. That is, you know, around trading, it's  
25 often said that I want to know what everybody else is doing,



1 but I don't want to give up any of my information.

2           And so we have a certain degree of mandated  
3 disclosure that makes everybody better off, and our exchanges  
4 and our regulations require in the equity business, in the  
5 fixed income business, in other areas, a certain amount of  
6 mandated disclosure. And it makes the market function much  
7 more efficiently, and we are all better off.

8           You know, and so for these reasons, I support  
9 better transparency, both with respect to short selling, with  
10 respect to short interest, and with respect to stock lending.  
11 Thanks.

12           MR. BRIGAGLIANO: Thank you, Dr. Angel.

13           David.

14           MR. CARRUTHERS: Thank you. Good morning. My name  
15 is David Carruthers. I'm actually the head of quantitative  
16 services rather than strategy at Data Explorers. So my  
17 position in the company is one where we're looking at data in  
18 a fairly neutral way. So I hope that my comments can  
19 primarily focus on what our data can tell you, and provide  
20 a bit of a backdrop to some of the discussion in this  
21 session.

22           Any discussion of short selling disclosure does  
23 have to clarify the reason why the disclosure is deemed to be  
24 useful. For long positions, disclosure is primarily avoiding  
25 a stealthy buildup of a control stake, so it's primarily to

1 protect the interests of minority shareholders.

2           When we look at short positions, we have to think  
3 equivalently of who is the disclosure aimed at protecting.  
4 In general, I think we would all agree that the objective is  
5 to prevent market abuse and prevent the development of a  
6 false market, or to prevent situations where market  
7 participants take advantage of a vulnerable company or simply  
8 a thinly traded market for stock shares.

9           In addition to my written comments, I'd like to add  
10 here a comment about the situation last year in Volkswagen  
11 shares, where despite the disclosure rules that are generally  
12 in force in Europe, although perhaps not so strongly in  
13 Germany, there was in fact a stealthy position, an enormous  
14 stealthy long position, built up in cash-settled options in  
15 Volkswagen shares by Porsche or their representatives. The  
16 sudden disclosure of that had an enormously destabilizing  
17 effect on the marketplace, and I'll talk about the short side  
18 of that later on.

19           In the experience of Data Explorers, data of short  
20 selling has a number of facets. It's primarily used for  
21 hedging by market makers, option dealers, arbitrageurs, and  
22 so on. That short selling is, as has been discussed in the  
23 previous panel, covered by a stock loan, especially since the  
24 2008 crackdown on naked shorting.

25           However, we should remember that there are OTC

1 derivatives such as total return swaps which may not actually  
2 involve any kind of underlying dealing in the stock or short  
3 sale.

4           Much of the concern, as has already been voiced,  
5 around short selling is centered on the illegal and well-  
6 documented and policed activity of naked shorting. However,  
7 directional shorting is clearly also controversial.  
8 Anecdotal or, rather, informal research on our part suggests  
9 that the directional shorting is around 20 percent of the  
10 total. The rest is for the hedging purposes.

11           A key question is: Does short selling create false  
12 markets, and does it or indeed can it drive down stock  
13 prices? There are various academic papers which suggest that  
14 covered short selling is generally beneficial to markets,  
15 gives greater liquidity in bid/offer spreads.

16           However, since auctioneers need a buyer, the impact  
17 of covered shorting should in general be neutral, only  
18 market-negative if there is an imbalance of buyers and  
19 sellers. However, naked shorting does allow, as we've heard,  
20 the unlimited creation of synthetic shares.

21           In our experience at Data Explorers, most short  
22 positions actually build up very slowly, not in such a way  
23 that would normally move the market. On the other hand, a  
24 very important phenomenon is where the accumulated short  
25 position may have to be unwound very quickly and we move the

1 price sharply upwards. Again, the Volkswagen case of 2008  
2 was an extreme example.

3           We were inundated at that time with requests for  
4 data about the size of the short position, and most of those  
5 requests were coming from short sellers concerned that their  
6 position was so big that the pain could go on for quite some  
7 considerable time.

8           So the irony is that if you disclose short  
9 positions in the same way as you disclose long positions, the  
10 people you may be protecting are the short sellers or long  
11 fund managers who are underweight of stock compared with a  
12 reference index.

13           A further point from our data is in general, with  
14 short selling, what we see in our data is the anticipation of  
15 news and events rather than, in general, the driving down of  
16 share prices; whereas what we do see is the technical driving  
17 up of share prices through short squeezes.

18           We've also seen a fair amount of evidence that the  
19 institutional ownership changes are as good at predicting  
20 share price movements. In other words, there is that same  
21 symmetry between the long and the short sides of the market  
22 when we look at what we might call informed traders.

23           The final two comments about transparency:  
24 Anonymous disclosure of short positions in itself is unlikely  
25 to harm the market. The issue comes when you set up some

1 kind of feedback loop, and the disclosure of the data then  
2 creates another round of activity. The Volkswagen situation  
3 is a case in point.

4           Finally, a question about public reporting versus  
5 private reporting. Our view is that there's room here for a  
6 strong public/private partnership, with public collection and  
7 private distribution that will almost immediately show which  
8 data items and metrics are the most valuable because those  
9 will be the ones that will be picked up by the private  
10 sector.

11           Those are my comments. Thank you.

12           MR. BRIGAGLIANO: Thank you, David.

13           Richard Gates.

14           MR. GATES: On behalf of TFS Capital, I would like  
15 to thank Chairman Schapiro and the Commission for inviting me  
16 to participate in this roundtable discussion. As the founder  
17 and portfolio manager of a 12-year-old asset management firm,  
18 I am eager to share in an open dialogue on ways to enhance  
19 regulations to better our industry.

20           I enter this discussion knowing that academic  
21 literature suggests that short sale transactions add  
22 liquidity to the marketplace, reduce bid/ask spreads, and aid  
23 in price discovery.

24           And outside of the two recent enforcement actions  
25 for Reg SHO violations, I have not seen evidence that

1 suggests that short sellers are responsible for pricing a  
2 security at a level that is inconsistent with its fair value.  
3 Restated, for the most part I don't think that short sellers  
4 manipulated prices or engaged in abusive trading during the  
5 financial crisis.

6 For these and other reasons, I believe that short  
7 sellers have an unfair reputation in the court of public  
8 opinion. However, I come to the Commission happy to know  
9 that it is carefully and cautiously evaluating any potential  
10 regulation changes related to short sale transactions.

11 Now on to the topic of the panel, disclosure.  
12 To me, good disclosure should meet two basic criteria. The  
13 first is that each disclosure requirement should stand on its  
14 own feet. In other words, it should provide real value to  
15 individual investors and the market as a whole, even when  
16 required costs are considered. And when considering costs,  
17 it is of course important to consider both the direct and the  
18 very real indirect costs that exist.

19 The second principle with respect to short sale  
20 disclosure is that short sale sellers should not be subject  
21 to more onerous requirements than long-only managers. The  
22 reason for this is that it creates an unlevel playing field  
23 in the market that favors one participant over another. It  
24 also furthers the misconception that we are irresponsible  
25 investors that need to be scrutinized closer than our long-

1 only counterparts.

2           With these principles in mind, I will make a couple  
3 quick comments on three specific disclosures.

4           The first is that in general, I think that a short  
5 sale disclosure should match disclosures that are required  
6 for long positions. More specifically, I think short  
7 positions should be reported alongside long positions in  
8 forms such as the 13F and the 13D.

9           In addition to serving a similar purpose to the  
10 current long reporting requirements, such short sale  
11 disclosures could also provide other value as well. For  
12 instance, by capturing positions on both sides of a trade, it  
13 could be determined that a manager has a large boxed  
14 position. Such information could provide insight into issues  
15 like empty voting.

16           Next up are failures to deliver. I don't think  
17 anybody, any of the panelists that I've seen in the last  
18 couple of days, want fails to exist in the marketplace.  
19 While I think it's still -- it's much less of an issue now  
20 than it was pre-Reg 204T, I'm a fan of having as much  
21 disclosure that the Commission thinks it needs to help it  
22 eliminate future fails and tighten up Reg 204T as necessary.  
23 Of course, the market's integrity is impacted by fails, and  
24 fails can occur on all different types of transactions.

25           The last specific disclosure requirement I hope our

1 panel discusses, with David's assistance, is the aggregated  
2 short sale data that is now reported twice per month by the  
3 exchanges. This is a widely used metric, and is one that I  
4 believe is very important.

5           Unfortunately, I also believe that is  
6 underestimates the actual number of shares sold short. Its  
7 major flaw is that it lacks positions held at non-U.S. firms.  
8 In addition, it's my understanding that it may also exclude  
9 positions held in arranged financing platforms, swaps, and  
10 enhanced leveraged relationships that are set up through the  
11 United States.

12           Unfortunately, I believe this data is the  
13 cornerstone needed to fully understand short sales, their  
14 corresponding purchases, and the stock loan industry overall.  
15 In other words, if we want to have a thorough understanding  
16 of what is happening in the financial markets, I suggest a  
17 careful analysis of what can be done to get this figure  
18 described more fully and completely.

19           Before I wrap up, I would also like to share one  
20 parting thought. That is, when putting all of this together,  
21 I encourage the SEC to consider the pending regulation to  
22 make hedge fund managers become registered.

23           If or when this gets enacted, these managers will  
24 be required to maintain hoards of transactional-level data  
25 that presumably will include a high percentage of the short



1 sale transactions that exist. With just this one change, the  
2 SEC will then have access to far more information on short  
3 sale transactions than ever before.

4 Thank you again for including me. I look forward  
5 to the dialogue.

6 MR. BRIGAGLIANO: Thank you, Richard.

7 Michael Gitlin.

8 MR. GITLIN: Thank you, Chairman Schapiro and  
9 members of the Commission, for the invitation to appear here  
10 today. I'm pleased to participate in this roundtable on  
11 behalf of T. Rowe Price to examine short sales, and in  
12 particular, to discuss additional transparency measures for  
13 short sale-related information. T. Rowe Price is an  
14 independent global investment management company, and we  
15 welcome the opportunity to be a part of the industry dialogue  
16 on important market practices.

17 As a starting point, we urge the Commission to  
18 continue to work closely with foreign regulators to encourage  
19 symmetry in the regulatory schemes across borders as more and  
20 more firms such as our operate and trade in a global  
21 environment. We are also supportive of the Commission's  
22 commitment to work with SROs to discuss additional public  
23 disclosure.

24 We firmly believe the benefits of public disclosure  
25 of short sale positions outweigh the potential drawbacks.

1 Added transparency in the form of regular public short sale  
2 disclosure reporting will help remove the mystique around  
3 short selling, will put all market participants on the same  
4 level playing field, and will provide regulators with an  
5 efficient tool to monitor short selling.

6 In formulating specific frequency reporting  
7 requirements and threshold triggers, we are in favor of a  
8 commonsense and fair approach whereby short selling would  
9 generally be no more or less onerous than current long  
10 position reporting requirements.

11 There will likely be many views on the specific  
12 details for both reporting frequency and threshold trigger  
13 questions. But we think the primary question of whether to  
14 report -- to require public disclosure for short sales is  
15 straightforward and indisputable.

16 Industry participants are currently required to  
17 publicly file long positions, and we see no reason why short  
18 sellers would not have to meet similar standards. We believe  
19 the market would benefit from such enhanced disclosure.

20 We think the time frame for short position  
21 disclosures can generally mirror the reporting timelines that  
22 exist for long positions. Similar to Section 13, we imagine  
23 two levels of reporting detail.

24 Firstly, largely symmetrical to 13F, there could be  
25 a standard quarterly reporting requirement for all short

1 positions that are above a de minimis threshold. Secondly,  
2 there could be another reporting requirement triggered when a  
3 short position reaches a significant threshold, due within  
4 ten days of execution, much like the 13D requirements. This  
5 approach is straightforward and consistent with long  
6 reporting requirements.

7           We think it's important to have threshold triggers  
8 in place that provide the market with a proper amount of  
9 transparency. Determining the proper thresholds for  
10 reporting should elicit varied opinions and commentary.  
11 Therefore, we think the Commission should examine relevant  
12 empirical data and ask for input from investors before  
13 determining these thresholds.

14           The real time tagging and display of short sale  
15 executions on the consolidated Tape would provide market  
16 participants with a more in-depth understanding of trading  
17 activities in any given security on any given day. By  
18 marking short sale executions as short on the consolidated  
19 Tape, we are creating an equal and fair marketplace whereby  
20 long sales would necessarily be recognized as having been  
21 sold long.

22           Another benefit of real time tagging and display of  
23 short sale executions is the demystification of short  
24 selling. The ongoing debate of what caused an individual  
25 security to decline would largely disappear with this added

1 level of transparency. We believe the benefits of the  
2 consolidated Tape reporting for short sales outweigh any  
3 additional costs.

4 In conclusion, while there are different empirical  
5 arguments for and against the uptick rule and other  
6 regulatory measures, we feel strongly the issue for short  
7 sale disclosure is just that, an issue of disclosure. We are  
8 in favor of short sale reporting requirements that largely  
9 mirror existing long position reporting requirements, and  
10 we're in favor of short sales being denoted as such on the  
11 consolidated Tape.

12 Market participants will know what is being sold  
13 long and short in any given security, and added transparency  
14 in this regard on a real time basis can only help to inform  
15 market participants and calm investors' concern about short  
16 selling.

17 Rumors, misinformation, finger-pointing, and the  
18 emotion around short selling can be addressed by both regular  
19 short position disclosure and consolidated Tape reporting  
20 requirements. Such information should be useful for  
21 regulators as they attempt to instill market confidence and  
22 monitor market manipulation.

23 I thank the Commission, and look forward to the  
24 discussion.

25 MR. BRIGAGLIANO: Thank you, Michael.

1           Jesse Greene.

2           MR. GREENE: I would like to thank Chairman  
3 Schapiro and the Commission for inviting IBM to participate  
4 in the Securities Lending and Short Sale Roundtable  
5 discussion. We applaud the SEC for hosting an in-depth  
6 review of short sale pre-borrowing requirements and  
7 additional short sale disclosures.

8           As we have indicated in our comment letter about  
9 the SEC proposed rules on short selling, capital markets are  
10 important drivers of our economy. Their purpose is to  
11 provide capital to business in order to advance our economy.  
12 And there are other consequences.

13           How a stock trades is often viewed as an early  
14 indicator of the health of a company, which impacts  
15 shareholders, customers, and employees. Corporations work  
16 hard to make sure the information in the marketplace about  
17 their firm is accurate and complete.

18           Corporations measure success of their effort via  
19 feedback from and dialogue with those who own and transact in  
20 their stock. We know the identity of the most influential  
21 long holders due to the stock ownership, as disclosed in  
22 Form 13F filings. We know little to nothing about large  
23 short positions and short selling activity due to the lack of  
24 disclosures by short sellers of their positions.

25           Investors' ability to access full and complete

1 information about the company in the marketplace is impacted  
2 by what the SEC does after today's meeting. It is imperative  
3 that the SEC work to restore confidence by putting in place  
4 regulations that prohibit manipulative trading tactics and  
5 foster a fair and balanced information flow to enable a  
6 stable marketplace trading on fundamentals.

7           We commend the Commission's recent efforts to  
8 address abusive short selling tactics. The SEC rules issued  
9 in October of 2008 and the adoption of interim final  
10 temporary Rule 204T tightened the controls around short  
11 selling, and are a step in the right direction to reduce  
12 fails to deliver and address potentially abusive naked short  
13 selling.

14           However, there are also opportunities for the SEC  
15 to improve transparency with regard to short sale disclosure  
16 standards. As detailed in our comment letter, we have  
17 suggested that the Commission consider a comprehensive  
18 regulatory framework for short sales that would improve  
19 market stability and restore investor confidence, including  
20 public disclosure of short positions held by institutional  
21 managers with equal rigor to Form 13F requirements for long  
22 positions.

23           A simple example demonstrates the point we are  
24 making. Under the federal securities laws and the SEC  
25 regulations implementing those laws, they apply different

1 disclosure standards for short positions in securities than  
2 are applied to long holdings.

3           For example, an institutional investment manager  
4 may have a long position in ABC Company, implying a bullish  
5 view of the ABC Company. What the ABC Company and the  
6 investor community do not know is that the same institutional  
7 investment manager may have a substantially larger short  
8 position in the ABC Company, which implies a very different  
9 view of the company's prospects.

10           As illustrated, it's not clear that the distinction  
11 for short and long disclosure standards has a rational basis,  
12 and it may result in misleading and incomplete information in  
13 the marketplace that diminishes the effectiveness of the  
14 required disclosures.

15           Transparency in our financial markets is critical,  
16 and institutional investment managers should not be allowed  
17 to conceal certain positions while being required to disclose  
18 others of similar magnitude.

19           It is vitally important that the securities laws  
20 provide for complete and balanced disclosure, and that these  
21 laws are applied in a fair and equitable way. We believe  
22 that parity in disclosure standards for short and long  
23 positions in securities is a significant step in restoring  
24 fairness to the capital markets.

25           Without it, issuers are unable to address the

1 concerns of those betting that their business will fail, as  
2 they would their significant shareholders betting on the  
3 company's success, and investors do not have the information  
4 to gauge the true value of equities.

5 Thank you, and I look forward to the questions.

6 MR. BRIGAGLIANO: Thank you, Jesse.

7 Joe Mecane.

8 MR. MECANE: Thank you, Chairman Schapiro and  
9 Commissioners. I appreciate the opportunity to offer our  
10 views today on the reporting and disclosure aspects of short  
11 sale regulation.

12 The NYSE believes that short sales are an important  
13 tool in the maintenance of an orderly market. We also  
14 believe that some information about short sales can be a  
15 useful tool for market participants.

16 For example, the NYSE, NYSE Amex, and NYSE Arca,  
17 offer daily and monthly short sale transaction summaries. In  
18 addition, NYSE and NYSE Amex offer customers a semi-monthly  
19 file that contains the reported uncovered short positions on  
20 securities listed on NYSE, NYSE Amex, and NYSE Arca. The  
21 data for this is obtained from the reports provided by member  
22 firms under FINRA Rule 4560.

23 Separate from these publicly available reports are  
24 regulations requiring audit trails and the marking of orders  
25 to identify whether a sale of an equity security is long or



1 short. These requirements assist the Commission and self-  
2 regulatory organizations in determining whether market  
3 participants are complying with regulations such as Reg SHO.

4           These two types of short sale reporting illustrate  
5 different policy objectives. The short interest report and  
6 the Exchange's proprietary short sale transaction reports  
7 respond to investor and company interests. The audit trail  
8 information, on the other hand, is needed to prevent and  
9 detect fraud and manipulation in the market. We believe it's  
10 essential to keep these different policy objectives in mind  
11 as we consider enhanced disclosure.

12           We believe the Commission should also bear in mind  
13 that there is a conflict between the potential benefit to  
14 investors and companies from disclosure of trading  
15 information and the proprietary interests of investors  
16 seeking to execute a particular trading strategy in the  
17 market.

18           The questions thus are, one, will any change in  
19 disclosure mandated by the Commission serve to materially  
20 enhance the market by providing investors and companies  
21 information that they need without encroaching on investors'  
22 legitimate need for confidentiality? And two, will the  
23 disclosure enhance a regulatory oversight objective?

24           Other factors to be considered include whether the  
25 costs of providing the information outweigh the benefits, and

1 whether the information may have unintended consequences.

2           We can apply this analysis to the questions that  
3 you've asked us to address. With respect to whether a short  
4 sale indicator should be added to the consolidated Tape, our  
5 view is, first, there appears to be little regulatory benefit  
6 from this disclosure because the information is already  
7 captured by market centers and is available to the  
8 Commission.

9           However, for a relatively low cost, additional  
10 disclosure of real time activity could be beneficial to the  
11 markets, although we should continue to evaluate whether that  
12 disclosure could have unintended consequences.

13           Increased short reporting may be of some benefit to  
14 investors and companies. The increased cost of collecting  
15 and providing this information should be incorporated in the  
16 cost/benefit analysis. But it's our view that the public  
17 disclosure of an investor's short position should be based on  
18 a policy determination that the benefits of public disclosure  
19 outweigh the principle of protection of otherwise  
20 confidential information.

21           A reasonable place to start could be disclosures  
22 similar to those under 13F or 13D, with additional public  
23 debate around the cost of more frequent or detailed level  
24 disclosures.

25           The NYSE's primary interest in increased short sale

1 disclosure is whether it will enhance the ability of  
2 regulators to detect and prevent fraud and the manipulation  
3 of stocks traded in our market. On that basis, there are  
4 compelling reasons for increasing the confidential disclosure  
5 of concentrated proprietary short positions on a more  
6 frequent basis for regulatory purposes as we continue to  
7 debate the cost and benefit of public disclosure.

8           Detection of manipulation is made more difficult  
9 today not only because the market for trading stocks is  
10 fragmented, but also because of the increase in derivative  
11 products and transactions. It's beyond the capability of any  
12 one market center to effectively police trading across one  
13 venue -- I'm sorry, across all venues.

14           We think the solution is to consolidate  
15 responsibility for market surveillance and to be sure that  
16 the designated regulatory body is equipped with the tools  
17 needed to perform that surveillance.

18           I look forward to your questions.

19           MR. BRIGAGLIANO: Thank you, Joe.

20           Michael Treip.

21           MR. TREIP: I'd like to thank Chairman Schapiro,  
22 the Commissioners, and the SEC staff for inviting the FSA to  
23 participate in this roundtable.

24           The FSA regards international dialogue and, where  
25 appropriate, convergence on short-selling regulation to be

1 critical. I personally wear two hats in this context. I  
2 have led much of the work developing the policy in the U.K.,  
3 but I also sit as the chair of the CESR -- that's the  
4 Committee of European Securities Regulators -- the CESR Task  
5 Force on Short Selling. So I have a twofold role.

6 It's worth mentioning a couple of points by way of  
7 background before I go on to a few key issues.

8 Since the 18th of September, 2008, the FSA has  
9 operated an individual position public disclosure regime with  
10 respect to U.K. financial sector stocks. In the first  
11 quarter of this year, we published a discussion paper where  
12 we indicated that we didn't favor any form of ban or direct  
13 restraint, but we did propose that we felt the most  
14 appropriate form of regulation was that holders of net short  
15 positions of 0.5 percent and above in all U.K. stocks should  
16 have to disclose those identifiable individual positions to  
17 the market as a whole.

18 We also thought that these obligations should kick  
19 in at a lower level, not 0.25 percent, where the company in  
20 question was engaged in a rights issue. These disclosures  
21 would be made by the end of the trading day after the day on  
22 which the position was reached. Those engaged in genuine  
23 market making activities would be exempt from the obligation.

24 We will, in fact, publish our feedback statement to  
25 these proposals tomorrow.

1           Proposals in a CESR consultation paper on  
2 disclosure that was published in July of this year are very  
3 similar to the FSA's, apart from the fact that CESR proposes  
4 that there should be one additional lower threshold for so-  
5 called private disclosure to the regulator, and that should  
6 be at 0.1 percent. That consultation, in fact, closes today.

7           So what is our thinking on what I see to be some of  
8 the key issues of interest today? We note, of course, the  
9 beneficial impact that enhanced transparency has on market  
10 efficiency. But I have to say our principal objectives in  
11 the short selling space are to mitigate the risks of market  
12 abuse and disorderly markets that we consider it to pose.

13           We believe this is best achieved by enhancing  
14 transparency of investors' short interest, howsoever the  
15 short position is reached. That is the reason for our  
16 interest in position reporting.

17           In addition, with one exception, the infrastructure  
18 for sales reporting simply does not exist in Europe, so the  
19 implementation costs of sales or transaction reporting would  
20 be very great indeed.

21           The second issue, as I see it: Why public  
22 disclosure? We do want the market as a whole to receive  
23 better quality information around short selling. But we also  
24 want to have some impact on investor behavior through a  
25 disclosure regime. And we feel it is very important to be

1 open and up-front about that motivation.

2           Let me come to that point now. Why identify the  
3 position holder to the market, as we propose? I can say  
4 unequivocally that we do not want to halt short selling in  
5 non-crisis market conditions. We recognize the beneficial  
6 role it plays in markets.

7           What we do want to do, however, is create a degree  
8 of deterrence against the most aggressive short selling by  
9 requiring short sellers to consider their trading strategies  
10 as they approach the public disclosure threshold.

11           We recognize that there are concerns in some  
12 quarters about phenomena such as herding; enforced disclosure  
13 of intellectual property, that's been mentioned already;  
14 short squeezes; and ultimately, it's argued, reduced levels  
15 of short selling; and lower market quality. But from our  
16 analysis of the impact of a disclosure regime in the U.K., we  
17 have not seen these concerns crystallize to date, so we think  
18 our proposed model strikes the right balance between  
19 competing interests.

20           Two further issues to mention briefly. Why no  
21 aggregation by the regulator, as is on the table from some  
22 respondents? Clearly, this can facilitate some of the  
23 informational benefits that we're looking to gain. But we  
24 think, because of the inherent anonymization that's involved,  
25 it will not result in any significant changes of behavior.

1 It also, I have to say, carries with it resource implications  
2 for the regulator.

3 And finally, why, as we proposed, disclosure at  
4 T + 1? We're not seeking to achieve genuine real time  
5 disclosure. With the current market infrastructure in  
6 Europe, this would be disproportionately burdensome on the  
7 market and unmanageable for the regulator.

8 However, if the market is to benefit from current  
9 and meaningful information and we are to have an impact on  
10 the most aggressive trading strategies, we do believe that  
11 disclosure should be timely. And our current measure of  
12 timeliness is one day.

13 Naturally, I know that there are many other issues,  
14 and I'm sure these will come out in the ensuing discussion.  
15 Thank you.

16 MR. BRIGAGLIANO: Thank you very much, Michael.  
17 Thank you, all the panelists, for your thoughtful statements.

18 We're now open for questions from the Chairman and  
19 Commissioners.

20 CHAIRMAN SCHAPIRO: Thanks, Jamie. I'd like to  
21 follow up with Michael. And I should start by thanking you  
22 for coming from such a long distance to help us today. We're  
23 very grateful for that.

24 You've had the benefit now of about a year's  
25 experience with your disclosure regime in the U.K., and you

1 highlighted some of the things people worried about that  
2 would result from the revelation about trading strategies or  
3 herding or other potential consequences of having a  
4 disclosure regime.

5           Were there any negative impacts, as you look back  
6 over the past year, from requiring the disclosure that you do  
7 require? And from your perspective, and I guess I'd like to  
8 know what industry would say was negative impact from the  
9 disclosure regime, or positive?

10           MR. TREIP: Thank you. I'm loath to start off with  
11 some caveats, but I feel I should. Firstly, we have to be  
12 cautious trying to extrapolate how -- a very broad scope  
13 regime is the one we're proposing -- may pan out on the basis  
14 of a really very narrow scope regime, which is what we've had  
15 to date. But that is the data we have.

16           Secondly, of course, that regime has operated in a  
17 number of contexts, which have almost certainly distorted any  
18 measurements that we can make. Firstly, for the first three  
19 or four months of the operation of our disclosure regime, we  
20 also had a ban in relation to the active creation or increase  
21 of short positions in U.K. financial sector stocks. So in a  
22 sense, we have to disregard that data because it's in that  
23 context.

24           We have actually worked a little bit with David's  
25 organization and looked at stock lending data. And although



1 our analysis to date has not been hugely sophisticated and we  
2 are working further, we really have seen relatively little  
3 impact, as far as we can see, from a stand-alone disclosure  
4 regime on levels of short selling.

5 We have seen changes, but those have really been in  
6 line with what we would expect from the underlying trends in  
7 the market. Levels of short selling seem to have gone down  
8 over the last few months, but pretty much at exactly the same  
9 level as the markets have broadly gone up, which is what we  
10 would expect.

11 So on limited data to date, we haven't seen an  
12 enormous negative impact. We did see some impacts from the  
13 period we had a ban in place, which we would not necessarily  
14 want to have on a long-term basis, such as a widening of  
15 bid/offer spreads. But disclosure alone, not a huge impact.

16 COMMISSIONER PAREDES: To pick up on an aspect of  
17 what you had just mentioned in terms of the studies, and  
18 you're still pushing further to kind of make them more  
19 robust, if you could maybe just say a little bit more about  
20 what the limitations are on the studies so far, and what the  
21 plan is on a going-forward basis, and why you think that will  
22 yield more robust results, whatever they happen to be in  
23 substance.

24 MR. TREIP: Well, one of the limitations -- and  
25 again, I'd really like to pick this up with David, perhaps in

1 the margins -- is that we've struggled a little bit to  
2 actually come upon what would be meaningful data to reflect  
3 herding behavior or squeezes. And clearly, those are two  
4 concerns which have been expressed very loudly. So David, if  
5 you have thoughts on what Data Explorers has seen in that,  
6 I'd be very interested.

7 The other limitation, of course, is that as we all  
8 know, stock lending data, which is really the main source of  
9 information we have, is a proxy, and it's not a perfect  
10 proxy, for levels of short selling.

11 And also, a third limitation is the point that's  
12 been made a number of times this morning, is that of course  
13 short selling is conducted for a number of reasons, some of  
14 which are relevant to our objectives and some of which are  
15 not. And some data would suggest that the majority of short  
16 selling is done for purposes which really have no link to our  
17 regulatory objectives.

18 So going forward -- I apologize, David; there was  
19 an element, a further element to the question -- we really  
20 are at a very early stage as to how we can make our analysis  
21 more sophisticated.

22 MR. CARRUTHERS: I can perhaps add to some of  
23 Michael's comments by telling about some of the research that  
24 we've done at Data Explorers. If I could also say thank you  
25 very much for the opportunity to present to you; I think I

1 may have omitted to do so in my opening comment. Apologies.  
2 I blame jet lag.

3           The work that Michael has mentioned was very  
4 interesting because we worked with the FSA, including a  
5 number of members of the market abuse committee there, some  
6 of whom had fairly extensive industry experience, having  
7 worked in investment banks themselves.

8           So there's really two things. One is a roundabout  
9 short selling in the form of covered shorting that you  
10 collect data on and you can identify and it's transparent.  
11 And here in the U.S., you do calculate short selling data and  
12 publish it every two weeks with a delay.

13           We've compared the stock lending that we collect  
14 with the public data. There's certainly a very considerable  
15 overlap. But if you think of it in terms of two sets  
16 overlapping, there's definitely situations where people  
17 borrow stocks, such as pre-borrows, which are not reflected  
18 in short selling; and situations where people short sell  
19 without it being reflected in a stock borrow, hedging being  
20 one of them.

21           So when it comes to the herding that you talked  
22 about, I think we can identify fairly closely, but not  
23 exactly, through stock lending data what the short side of  
24 the market is up to, at least where its legitimate activities  
25 are concerned.

1           The points I made about Volkswagen apply here, that  
2 some of the largest positions that we see -- and I'm talking  
3 about where the percentage of a company's shares that are  
4 actually on loan and hence broadly shorted are perhaps over  
5 5 percent, which would be a typical disclosure for a long  
6 position.

7           Once you get to that stage and beyond, there is  
8 actually a very significant danger that there will be a short  
9 squeeze. There will be short covering. And anyone who is  
10 short is extremely vulnerable to that because if you think  
11 it's unpleasant to be on the receiving end of a falling share  
12 price, it's even worse to be on the receiving end of being  
13 short when share prices are rising. The panic levels around  
14 about the Volkswagen situation and the Citigroup short  
15 squeeze earlier this year were evidence of that.

16           Where I think the conversations with the FSA  
17 revealed some very interesting points was around about the  
18 definition of naked shorting. We discussed this for about  
19 two hours, and it became obvious that there are a number of  
20 ways in which naked shorting can actually manifest itself,  
21 which are very difficult to track down.

22           The previous panel talked about the level of fails,  
23 which is certainly one of the ways you can track it, but not  
24 the only. There's also the possibility of putting a trade on  
25 and then disappearing off to get a coffee, coming back and

1 closing it out again, all within the space of half an hour.  
2 That in itself is a form of short selling.

3           And there's the derivatives that I mentioned, where  
4 you can create a contract which replicates the behavior of  
5 shorting without there being an underlying trade, and the  
6 risk is on the side of the person who decides to write that  
7 contract and not hedge it.

8           So in reality, the naked shorting is a little bit  
9 like water. It flows through all sorts of cracks everywhere.  
10 It can be very, very difficult to make that completely  
11 watertight.

12           COMMISSIONER PAREDES: On the disclosure point, I'm  
13 curious, going to the professor, whether or not there's any  
14 relevant academic literature that gets at -- whether from an  
15 empirical perspective or perhaps a theoretical perspective,  
16 given the limits of the data, that would offer some insights  
17 in terms of what the expected results are from different  
18 types of disclosure.

19           You had mentioned, I think, in your remarks that  
20 there's a whole lot of benefit to having more transparency in  
21 these respects. But a couple of you recognized that at some  
22 point there of course are costs that need to be factored in.

23           And I'm curious, in terms of the academic take on  
24 it, what is out there again, either empirically or  
25 theoretically.

1 DR. ANGEL: I'm not aware of any academic studies  
2 that look at any transparency regimes that are of interest  
3 here. We have seen in areas like with bonds, for example,  
4 that when we got better price data, the bond market  
5 functioned better.

6 One thing I would suggest, since short selling  
7 represents 25 percent of our equity trading volume, that we  
8 carefully design any changes in a way that we can investigate  
9 the results. For example, phasing in new disclosure regimes  
10 or, better yet, having carefully controlled pilot  
11 experiments, as was done with Regulation SHO. In that way we  
12 can intelligently gather the data we need to find out, you  
13 know, the impact of any new disclosure regime.

14 CHAIRMAN SCHAPIRO: Could I -- I want to make sure  
15 I understand. In the U.K. regime, and I guess what's  
16 contemplated with CESR, is non-anonymous disclosure,  
17 disclosure by entities of short positions. Is that correct?

18 MR. TREIP: That is correct. The CESR proposal  
19 would have a private disclosure to the regulator at a low  
20 level, and then at the more significant level, a public  
21 identifiable disclosure.

22 CHAIRMAN SCHAPIRO: Okay. So David Carruthers, I  
23 don't want to put you on the spot. But your submission talks  
24 about "Anonymous disclosure of short positions is unlikely to  
25 directly harm the market."

1           Do you have a view about identified disclosure?

2           MR. CARRUTHERS: I think the critical issue is the  
3           timelag. I think that if you have disclosure a few weeks  
4           later or a few months -- it depends on someone's trading  
5           strategy -- but in general, if some time after the fact it's  
6           named, then in general, that shouldn't be an impact.

7           I think it was mentioned earlier about the  
8           prisoner's dilemma, the problem that you have with markets,  
9           that if we have full transparency, you may reach a situation  
10          where no one would trade because everybody knows everybody's  
11          positions.

12          So the FSA's definition of timeliness is one day.  
13          I would imagine that if you were to name the -- if you were  
14          to make it non-anonymous, it would certainly have to be  
15          significantly more than one day for the market participants  
16          to feel comfortable. It really depends on their turnover  
17          level, how fresh that data is and whether it would place them  
18          in a disadvantageous position.

19          CHAIRMAN SCHAPIRO: Do others of you have views on  
20          that, on anonymity?

21          MR. GITLIN: One thing I'd say is when we're  
22          contemplating looking at herding and short squeezes, if we  
23          look at a level playing field -- and that's one of our  
24          missions, is try to get a level playing field -- on the long  
25          requirement right now, when someone like T. Rowe Price

1 reports its positions in 13F filings, we have the same risk  
2 of effectively long squeezes.

3           When we own up to 15 percent of companies and when  
4 we report in our 13F filings, we have the same risk of people  
5 seeing that filing, noting T. Rowe Price may own a 5 percent  
6 position and may be on its way to a higher position and then  
7 could buy ahead of us as well.

8           So I would just think of that in the context of a  
9 level playing field and timelines.

10           COMMISSIONER WALTER: Can we talk for a few moments  
11 about the exceptions that are in the U.K. and proposed CESR  
12 regime? As I understand it, there is one for market maker  
13 transactions that are bona fide, genuine market maker  
14 transactions.

15           And I wondered if, Michael, you could comment on  
16 why it's there, how you define it, and what other types of  
17 exceptions you think might be appropriate.

18           MR. TREIP: Certainly. Commissioner Walter, you  
19 rightly identify that the market maker exemption -- really in  
20 carving out that role from obligations.

21           But we are recognizing the role that short selling  
22 generally, and particularly market makers, plays in relation  
23 to liquidity. And we do feel that it's very important not to  
24 over-egg the pudding, if I can put that way; and to impose a  
25 disclosure obligation without any exemptions whatsoever could



1 actually take the impact on liquidity too far.

2           We are -- that's our core principle at stake.

3 There have been arguments from some quarters within Europe  
4 that we should actually have a very broad definition, that we  
5 should actually talk about liquidity providers rather than  
6 market makers.

7           We in the U.K. feel that that would be taking it  
8 too far. That's creating a charter for an awful lot of  
9 people who will put their hands up saying, yes, we provide  
10 liquidity, too, so we don't have to make any disclosures.

11           So we are holding the line. And there is a  
12 consensus in Europe that that line should be held on this  
13 concept of market making. That then begs the next question  
14 as to how precisely we should define that.

15           The FSA has put forward a definition -- I won't go  
16 into the precise details of it -- in our frequently asked  
17 questions, which does slightly diverge from our technical  
18 definition in our rule book.

19           But one thing we are conscious of within the  
20 European context, again, is to avoid a proliferation of  
21 definitions. Market makers are defined, I believe, already  
22 in three different ways in three contexts within European  
23 legislation. So we have to be careful. We have to be  
24 cautious about creating a fourth definition.

25           COMMISSIONER WALTER: So is it principally -- are

1 there any other significant exceptions, and the rationale for  
2 this one that makes sense is the liquidity provision function  
3 that's being served on a pretty constant basis. Are there  
4 other rationales that would justify exemptions as you  
5 consider those?

6 MR. TREIP: Well, we've had various representations  
7 made to us. One that was mentioned relatively recently when  
8 I attended a CESR open hearing was that positions as a result  
9 of ETF trading or indices trading or basket trading should be  
10 exempt.

11 Our feeling quite strongly, and I know that there  
12 is a CESR consensus on that, is that that should not be  
13 exempt. We recognize that it may create logistical  
14 difficulties in actually determining your precise position in  
15 relation to the components of an index, for example.

16 But let's say if you look at what -- the regulatory  
17 objective we're seeking to achieve, we feel that the same  
18 risks apply, and therefore the same solutions should be  
19 applied to them.

20 COMMISSIONER WALTER: Thank you.

21 Do others of you have any things about any other  
22 aspects that you think deserve exemption from a disclosure  
23 regime?

24 MR. MECANE: I would just add that I think it's  
25 important to look at that question and a number of the other

1 issues in the context of activity versus positions because  
2 there tends to be, I think, a lot of confusion in general  
3 with regards to those two types of disclosures.

4 I think with respect to positions, you probably  
5 don't need exemptions because, by definition, market making  
6 tends to be flat and not carrying a lot of inventory, so  
7 positions wouldn't necessarily need an exemption.

8 But I think with respect to activity, and when I  
9 mentioned unintended consequences with respect to putting  
10 short sale locator on the Tape, I think that's where you have  
11 the potential for a lot of confusion.

12 Because you could end up seeing a very large amount  
13 of short selling activity happening throughout the day,  
14 especially in the way that, you know, the high-frequency type  
15 activity has evolved, that doesn't actually result in short  
16 selling activity -- I'm sorry, in a net short position at the  
17 end of it.

18 And there's nothing -- there's no issue with that  
19 other than it makes it very difficult to interpret what value  
20 you get out of the disclosed activity because you can't  
21 necessarily dissect all the short selling activity that  
22 happened and what's behind it, meaning there could be a very  
23 large amount of activity that happens that does not end up  
24 any net short position. But someone just looking at the Tape  
25 or looking at that data has no way to see that.

1           So I think that there's a valid case to be made  
2 around whether, you know, exempting market making activity  
3 from a more real time disclosure might help improve the  
4 quality of the activity disclosure. I think then, you know,  
5 where that evolves into and where it gets very, very  
6 complicated is that, you know, how do you define that  
7 activity that should be subject to the exemption?

8           And obviously, we're dealing with that in a number  
9 of different contexts in terms of how to define a market  
10 maker because you could exempt a certain type of activity,  
11 and then a lot of activity that doesn't necessarily qualify  
12 for it ends up, you know, behaving similarly.

13           So it's a difficult question, obviously, to  
14 resolve. But it's something that I think should be part of  
15 the debate.

16           MR. POLISE: Joe, can I follow up on something  
17 quickly on that? I'd like to talk about it not from the  
18 public disclosure aspect, but from the regulatory disclosure  
19 side.

20           MR. MECANE: Yes.

21           MR. POLISE: And when we make the distinction  
22 between activity and positions, the relative merits of the  
23 pre-marking requirement -- for example, pre-trade, when  
24 somebody's doing a high frequency trade, which may end up in  
25 a net flat position, versus the post-execution disclosure.

1           From a regulatory purpose, I think I would take a  
2 different tack, which is you need to know what the intent is  
3 at the time the trade is executed -- I'm sorry, at the time  
4 the trade is put in.

5           MR. MECANE: Right.

6           MR. POLISE: And I was wondering if Michael had any  
7 thoughts on that from the United Kingdom as well.

8           MR. TREIP: I do apologize, Brian. I was just  
9 making a note of something else. I didn't quite catch the  
10 second half of your question.

11          MR. POLISE: The relative merits of a pre --  
12 sorry -- order entry marking regime versus a post-execution  
13 net position. That is, it comes up more frequently with high  
14 frequency traders who may not know or claim not to know  
15 whether they're actually going to be short or not at the end  
16 of the trade.

17          MR. TREIP: It's a fair question. I mean, we  
18 recognize that with high frequency trading, and indeed with  
19 intra-day short selling, which in the U.K. we believe makes  
20 up much of the naked short selling activity, it's not going  
21 to be captured by the sort of position regime we have. The  
22 problem -- and, you know, an obvious solution for means of  
23 creating transparency in that space would be through having  
24 flagging or marking of transaction reporting.

25          The stumbling block, as I've mentioned already, in

1 Europe is that that infrastructure simply doesn't exist. And  
2 we do feel that the very great costs of putting some kind of  
3 marking regime in would then really strain the cost/benefit  
4 analysis.

5 MR. POLISE: But Joe, you think that's probably  
6 possible here in the United States? We have a fragmented but  
7 still somewhat centralized market, maybe not for public  
8 disclosure but for audit trail purposes.

9 MR. MECANE: Right. I mean, I think the issue that  
10 you're raising is more around how a lot of the high frequency  
11 business models have evolved over a number of years. And I  
12 think there's consensus. You know, there's been a lot of, I  
13 think, debate on both sides of that issue in terms of how  
14 orders should be marked.

15 And I think it's largely an outcome of the fact  
16 that, you know, a lot of strategies are executing or at least  
17 posting orders in multiple markets simultaneously. And so,  
18 you know, the intent is really for only one of those orders  
19 to get executed. But obviously, you know, they're spreading  
20 their interest around in the hopes that, you know, of those  
21 will get executed and they could cancel the balance.

22 So I think, to your point, to the extent that the  
23 reporting requirements in those situations get harmonized and  
24 become more of a pre-trade definition of what your intended  
25 activity is, it certainly helps clean up the audit trail. My

1 point was more even if we go in that direction and all the  
2 trades that we consider to be short are marked as such before  
3 the fact, those trades could subsequently be covered,  
4 shorted, covered, you know, very frequently throughout the  
5 day.

6 And from a public disclosure standpoint, seeing all  
7 that activity and just looking at, let's say, what the net  
8 effect of all the shorting is is difficult to know because,  
9 you know, positions are established and covered continuously.

10 So I think the clarification that's out there  
11 simplifies the definition of what short sale activity is.  
12 But I think you still end up with a feedback mechanism.

13 CHAIRMAN SCHAPIRO: That's a really interesting  
14 discussion, I think, about the potential for putting an  
15 indicator, a short sale indicator, on the Tape.

16 I wonder if any of the others of you have any view  
17 about that, and whether there would be any advantages to  
18 having that kind of information available, perhaps in some  
19 way to provide the context so that it's not misleading to  
20 investors.

21 MR. GITLIN: I think one of the interesting things  
22 about having it denoted as such on the consolidated Tape, in  
23 what Joe describes, what you'd end up with is information in  
24 itself. So if what Joe describes would occur, where there'd  
25 be lots of trades that ended up net but looked like shorts on

1 the Tape, that ended up flat at the end but were actually  
2 shorts, that's good information for market participants to  
3 know that a lot of the activity in that name was actually  
4 just electronic market making activity and not fundamental  
5 activity.

6           And that's an important piece of information for  
7 the marketplace. So I would use that as a reason why marking  
8 on the consolidated Tape -- and from what I understand from  
9 both NASDAQ and NYSE is that that can be done tomorrow -- why  
10 that would be a benefit for participants as a whole.

11           I don't know if the professor has any thoughts on  
12 that, but I think I've read in one of your comments that you  
13 thought that might be positive.

14           DR. ANGEL: Yes. I concur. I believe that the  
15 instantaneous real time marking would help to assure  
16 investors that there is a lot of legitimate short selling  
17 that you see under normal circumstances, that not every short  
18 seller is a predator, and that if there is an abundance of  
19 short selling, people can see it, you know.

20           So in this way we won't have people wondering about  
21 what kind of mysterious conspiracies are taking place in the  
22 dark. So I think transparency on a trade-by-trade basis is  
23 something that we can achieve easily, at low cost, and with  
24 very little harm to the rest of the market. So I think we  
25 should do it.



1           MR. MECANE:  If I could just add, very quickly,  
2 just to clarify one thing.  So it's definitely something that  
3 could be easily done.  And just to be clear, we are in favor  
4 of that level of disclosure.

5           I think, though, to the point that Michael just  
6 made, if you have the activity but not the position, it then  
7 becomes difficult to back into how much is transactional  
8 versus establishing a position.  So I think the two are  
9 somewhat related, meaning they go hand in hand.

10           The issue that comes up is just the time lag  
11 between those two because, you know, assuming we had a 13F or  
12 13D type regime, we just need to recognize that there's a  
13 time lag involved if we're doing real time activity  
14 reporting, but then delayed position reporting for valid  
15 reasons.  There's just a time lag between people -- you know,  
16 for people to be able to do that analysis to separate the two  
17 pieces out.

18           MR. CARRUTHERS:  If I could add one comment from  
19 our experience.  We collect quite a lot of regulatory data  
20 already, and we do collect around about 3 million  
21 transactions every day.  And what I can tell you is it's  
22 quite a lot of work to take all of that and then turn it into  
23 something more meaningful, both from the point of view of the  
24 transactions and the overall position size.

25           I think when it comes to transactions, part of the

1 objective, I think, with disclosure there is almost to  
2 discourage the mere fact that you're requiring disclosure.  
3 And that it will be a matter of public record then  
4 discourages some of the activities that you're concerned  
5 about.

6           On the other hand, the collection of the aggregate  
7 or the net position can lead to a whole series of subsequent  
8 additional questions. We certainly find that taking the raw  
9 data and aggregating it in such a way that we address the "So  
10 what?" question from our clients is not a trivial  
11 undertaking.

12           So I think that it's certainly a very important  
13 first step to giving the reassurance that the activities  
14 you're talking about will at least be captured.

15           MR. GREENE: Let me comment from an issuer's  
16 perspective, because we have, I think, come at it from a  
17 slightly different perspective. We work very hard, as I  
18 indicated in my remarks, to communicate with our investors  
19 about issues about the company.

20           And when we find out about a rumor or concern about  
21 some part of our company, at the next earnings call or an  
22 analyst meeting or even an 8-K, if necessary, we will try to  
23 address those issues.

24           Information about short selling that's coming  
25 across the Tape is information we can use that indicates

1 something is going on, that maybe we need to find out what is  
2 the issue that's behind it.

3 So from our perspective, we support having the  
4 indicator in the consolidated Tape. We think it's a valuable  
5 piece of information from an issuer perspective.

6 MR. BRIGAGLIANO: Can I ask if trades were marked  
7 short, could or should there be a designation for "buy to  
8 cover" trades to provide the counterpoint information so that  
9 investors would understand whether a short might be  
10 directional or not?

11 DR. ANGEL: Well, as an academic, I'd love to see  
12 that data. But I'm concerned there may be a lot of  
13 operational problems in that the person putting in the trade  
14 may not necessarily know whether they are covering a short  
15 position, so that I think it would lead to additional  
16 compliance and enforcement burdens.

17 So I'd say, for now, start with the simple thing.  
18 We already mark trades long or short. The exchange systems  
19 already have the data internally. It's a very simple thing  
20 to go forward and release that data publicly. To require  
21 additional marking would be a much bigger step.

22 MR. BREHENY: Can I ask, a number of you commented  
23 on the importance that you believe in leveling the playing  
24 field between long and short position reporting. But if I  
25 understand it correctly, in the U.K. the long report

1 threshold is at 3 percent, and the current proposal is to  
2 have the short positioning reporting at 0.5 percent.

3           So I'd ask you: If the Commission was to think of  
4 potentially extending the requirements that we have now for  
5 long reporting at 5 percent, 10 percent -- 10-day reporting,  
6 like in the 13D, and also thinking about 13F -- and as you  
7 know, 13Fs are filed by institutional investment managers as  
8 that term is defined in the Commission's rules -- could you  
9 see the reason why the thresholds and the timing and other  
10 disclosure may not -- may not make sense for those to mirror  
11 each other?

12           DR. ANGEL: Yes. There's a very good reason for  
13 asymmetric treatment of short selling versus long activity,  
14 and that is that the alleged allegations against short  
15 selling are that the short sellers have an incentive to  
16 destroy productive enterprises.

17           And since the purpose of our capital markets is to  
18 promote capital formation, to promote efficient risk-sharing,  
19 to promote enterprise, if somebody has an incentive to do  
20 something bad to our productive companies, that indicates a  
21 lower threshold for disclosure than for a long investor.

22           MR. MECANE: One thing I'd add, just conceptually,  
23 is that as a lot of people know, the logic for disclosing the  
24 long side was largely based on a determination that as  
25 someone moves towards voting control or, you know, towards

1 being able to exert influence over the company, that that's  
2 something that should be -- that should be publicly  
3 disclosed.

4 And so, you know, that exact logic doesn't  
5 necessarily apply in this case. Similar to what Professor  
6 Angel was saying, I think one perspective is that on the  
7 short sale, we're largely worried about manipulative-type  
8 behavior.

9 And so I think one way to separate the argument is,  
10 similar to the logic the FSA is using but the numbers, I  
11 think, need to be debated publicly, is there could be a  
12 different level for private disclosure to the regulators, who  
13 are primarily concerned with potential manipulative-type  
14 behavior; and then public disclosure to investors, issuers,  
15 et cetera, which might not be at as granular a level, but  
16 makes the public disclosure more meaningful and more  
17 applicable.

18 So one way to think about the debate is separating  
19 those two pieces out because it is a different policy  
20 objective than we necessarily had on the long sale, or with  
21 insiders and so forth.

22 MR. BREHENY: I don't want to put Michael on the  
23 spot. But if you could give us any gloss on how you came up  
24 with the threshold, that would be helpful, too.

25 MR. TREIP: Well, I'll certainly come to that in

1 just a moment. But I would -- I would reiterate the  
2 sentiments that it is critical in our minds to look at the  
3 fundamental objectives of transparency for long versus  
4 transparency for short.

5 Certainly in Europe, the underlying philosophy for  
6 transparency for long positions is to shed light on voting  
7 rights. And the thinking is that that has to be referenced  
8 against the entire issued share capital.

9 Whereas if you're looking at the regulatory  
10 concerns that are posed by short selling, we're really  
11 looking at the potential impact that the short selling has on  
12 price movements and on trading.

13 And that really, in our mind, is referenced against  
14 a much lower figure. It's a reference against the daily  
15 volumes and so on. And that really brings us to how we came  
16 up with the thresholds.

17 And I have to say -- and this is probably not of  
18 comfort to everybody -- but there's as much art in this as  
19 there is science. I mean, it has to be said that that  
20 becomes even truer when you're looking at a one-size-fits-all  
21 regime for all types of stocks, and a regime, as is proposed  
22 within Europe, across all manner of different markets, some  
23 of which are very large, like our own, and some of which are  
24 really quite small and quite illiquid.

25 So it's a very difficult area. There's a high

1 degree of compromise. Our starting point in reaching the  
2 figures, certainly, in the U.K. was that we started off with  
3 a regime based on U.K. financial sector stocks. And we  
4 looked at the daily volumes and tried to come up with a  
5 figure that seemed to be a meaningful proportion of the daily  
6 volumes.

7 My recollection is that it was somewhere around the  
8 sort of 10 percent mark, that if your position represented  
9 something around 10 percent of the daily volumes, then that  
10 really could have an impact and cause a concern.

11 That was -- that was where we came out with U.K.  
12 financial sector stocks. It was also where we came out  
13 with -- came out in relation to rights issue stocks, which  
14 were just financial sector stocks but have an inherent  
15 vulnerability, obviously.

16 When we then looked at a broader scope regime, we  
17 felt that it was -- inevitably, we would need to be pushed  
18 up, that meaningful short positions in relation to  
19 non-financial stocks were going to be higher.

20 The share price and shorting in relation to  
21 financials, obviously, has a very direct link to consumer  
22 confidence, a much closer link than in relation to -- for  
23 financials has a much closer link than in relation to  
24 non-financials because ultimately you might have a run on a  
25 bank if people don't like the way it's going.

1           So we felt, inevitably, a broad regime would  
2 probably have to be higher. And 0.5 in the end was kind of  
3 where we came out with, as I say, perhaps as much art as  
4 science. We also recognized that once a regime has been in  
5 operation for a while, it may well be necessary to take  
6 another look at those thresholds to see whether they are  
7 producing the right type of information and are creating the  
8 right level of burden and not too much regulatory burden.

9           MR. CARRUTHERS: Michael, if I could just add a  
10 couple of points of information to that. I mean, it was  
11 mentioned on the Tape, at the moment, around 20 percent of  
12 all sales -- of all transactions are short sales. So that  
13 would certainly lead you to scale things potentially  
14 differently.

15           The point that you made, Michael, about the traded  
16 volume is a very important one, as well. There is, I think,  
17 what is called a trader's rule of thumb, that it costs you  
18 one day's volume, volatility to trade one day's volume.

19           So when markets are particularly volatile, again,  
20 there might be an argument for varying the thresholds because  
21 the impact that you would have on the shares prices would be  
22 different, depending on the market regime.

23           So that's just two little points of information  
24 that's worth bearing in mind.

25           MR. GATES: I wanted to comment real quick on the



1 professor's comments earlier. I have a different perception  
2 of the value of short selling. To me, short sellers aren't  
3 out to destroy value or to hurt the capital markets. Rather,  
4 my opinion is that they are a big part of the markets because  
5 they help reflect the true value of securities.

6           Since we've been managing money at TFS the last  
7 12 years, the two -- there have been a lot of interesting  
8 times in the market. But two of the most interesting were  
9 the tech bubble, and the credit crisis and the real estate  
10 bubble. Both of those events have something in common in  
11 that they have the word "bubble" in their names.

12           So to me, short sellers are an important part to --  
13 I guess I should say that long sellers are -- or long buyers  
14 have gotten more out of control than short sellers the last  
15 12 years.

16           In addition, I think there are two important  
17 characteristics about short sales that differentiate them  
18 from long transactions. The first is that they have  
19 unlimited downside and only offer limited upside. That makes  
20 them a lot scarier than buying a security. For that reason,  
21 I think, most short sellers enter into transactions wary, and  
22 rightfully so.

23           The second is that it's easier to punish an over-  
24 zealous short seller. If a security is driven too low, an  
25 individual could come and purchase the company the following

1 day and drive the price up higher. It's harder to punish an  
2 over-zealous purchaser. If a stock is -- pets.com is driven  
3 up to huge multiples, there's not much you can do to properly  
4 reflect its value.

5 And for that reason, I don't think that people who  
6 buy securities -- the bubbles that are created are not as  
7 easily pierced.

8 MR. GREENE: From our perspective, we see no reason  
9 why the rules, disclosure rules for short selling, should be  
10 any more lax than for long holders. You know, our  
11 perspective, it's all information about the views people have  
12 taken about the company. And it's information important to  
13 the issuer, and it's important information for the investor,  
14 too.

15 So from our perspective, there ought to be at least  
16 comparability between long and short positions.

17 MR. GITLIN: Just getting back to the threshold  
18 trigger question, I'd say at this stage I don't know if  
19 anybody is basis point smart. But whether it's 25 or  
20 50 basis points, I would say as Hong Kong and the U.K. and  
21 CESR look at different threshold triggers, having something  
22 that's globally aligned would probably make sense.

23 So if everyone is coming the line of 50 basis  
24 points, not 25, I would say we don't have the basis right now  
25 to have an opinion on that. But I think symmetry on a global

1 basis wherever possible is probably a good thing.

2 DR. ANGEL: I would like to correct a  
3 misconception. I think that most short selling is good and  
4 helpful to the market. But there are abuses that we do need  
5 to be aware of.

6 As far as symmetric treatment of long and short  
7 positions, I think there is a legitimate concern that  
8 disclosing every short position in an institutional-type  
9 filing might actually give away some important investment  
10 strategies.

11 There are two ways around that. One is de minimis  
12 exception. You know, if somebody is doing a pairs trading  
13 type strategy and they don't really want to give away how  
14 they're coming up with their pairs to trade, well, then,  
15 they're probably doing a lot of those, and there's probably  
16 not a large fraction of the stock involved. So a de minimis  
17 exception would deal with the "We don't want to reveal the  
18 strategy" problem.

19 The second way to deal with the "We don't want to  
20 reveal the strategy" problem is to allow on a case-by-case  
21 basis the SEC to make a decision as to whether, you know, a  
22 particular disclosure could be kept confidential for a period  
23 of time.

24 MR. BRIGAGLIANO: We've got one more minute. Jesse  
25 Greene, is there an important reason why issuers want or need

1 to know the identity of large short sellers in their  
2 securities?

3 MR. GREENE: Yes. Having the information there's a  
4 large short position out there doesn't help you find out what  
5 the problem is and what the concerns are about the company.  
6 A short position is essentially a bet against the company, a  
7 bet against its performance.

8 From our perspective, we want to go and talk to  
9 that particular short seller and find out what is his  
10 problem. And is there something that we haven't disclosed or  
11 something that we haven't described well that will help the  
12 marketplace understand us better?

13 So without the information about who the short  
14 seller is, we don't have the information we need to take that  
15 action.

16 MR. GITLIN: Jamie, one thing I would add to that  
17 is that gets along the beneficial ownership argument and  
18 discussion, which is probably -- we don't have enough time  
19 this week to discuss.

20 But I would suggest that that's one along the lines  
21 of what Jesse suggests, that if you imposed new regulations  
22 regarding short sale disclosure and you didn't have a  
23 beneficial ownership issue that you'd had to go along with  
24 that, you'd have short sellers hiding positions by shorting  
25 them on swap.

1           So I would highly suggest doing more and more work  
2 on beneficial ownership when it comes to reporting short sale  
3 disclosure.

4           MR. TREIP: Can I just chip in with an observation  
5 in relation to that? And I was quite encouraged by what  
6 Jesse said because a representation that has been made to us  
7 in the course of our consultation, if you can call it that,  
8 certainly, in Europe is that in fact a practice of requiring  
9 the identity of short sellers to be revealed publicly will  
10 actually close off the dialogue between short sellers and  
11 issuers, will actually stop those information flows; whereas  
12 what you're suggesting is possibly that that's not the case.

13           MR. GREENE: I don't see why it would. Certainly  
14 the short seller can always refuse to answer the question  
15 about what your concern -- our concern is. But it's  
16 certainly not going to stop us from asking the question,  
17 that's for sure. And it enables us to really target the  
18 question at the party that's taking the action.

19           MR. BRIGAGLIANO: Unless there are further  
20 questions from the Commission, we've now reached the end of  
21 today's roundtable discussion on short sale, pre-borrow, and  
22 disclosure requirements. On behalf of the Division of  
23 Trading and Markets, Division of Corporation Finance, and  
24 Division of Enforcement, I want to thank our panelists for  
25 their insights and candor.

1           I will now turn the program over to Chairman  
2 Schapiro for her closing remarks.

3           CHAIRMAN SCHAPIRO: Thank you very much, Jamie,  
4 Brian, and John for your great work today in moderating our  
5 final panel.

6           First, on behalf of myself and my colleagues on the  
7 Commission, I sincerely want to thank all of you for your  
8 participation today. We know you are all very busy people,  
9 and that you spent time preparing for and joining in this  
10 discussion. We appreciate that so many of you traveled to  
11 Washington for this event, including two of you who've come  
12 from as far as London, but from other locations, as well.  
13 And I want to thank my colleagues on the Commission for your  
14 helpful and insightful questions throughout these two days of  
15 roundtables.

16           Our decision to hold today's panel discussions is,  
17 I think, a reflection of our very deep commitment to  
18 approaching short selling issues in a thoughtful and  
19 deliberative manner, with the interests of investors foremost  
20 in our minds.

21           In that spirit, we are very committed to closely  
22 reviewing and weighing the potential merits of any additional  
23 short selling regulations such as pre-borrow or hard locate  
24 requirement or additional public or nonpublic disclosure  
25 requirements.

1           I think that today's conversation and discussion of  
2 these issues, with lots of opposing views, will be enormously  
3 valuable to us as we move forward and think about our next  
4 steps.

5           Today's panels particularly well complement, I  
6 think, the discussion we had yesterday about securities  
7 lending. And again, we're just so fortunate over the course  
8 of two days to have brought together so many experts.

9           Before we disband, I want to thank the key members  
10 of our staff who brought their skills and efforts to bear to  
11 make today's event possible. And they include Josephine Tao,  
12 Tory Crane, Liz Sandoe, Jeff Dinwoodie, David Bloom, Katrina  
13 Wilson, and Andrea Orr, and of course our moderators, who are  
14 sitting here with us, as well.

15           And once again, thank you all on the panel so much  
16 for your time and your assistance to us. Thank you.

17           (Applause.)

18           (Whereupon, at 12:26 p.m., the roundtable was  
19 concluded.)

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3 In the Matter of: SECURITIES LENDING &amp; SHORT SALE

4 Witness: Roundtable

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6 Date: Wednesday, September 30, 2009

7 Location: Washington, District of Columbia

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