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September 13, 2006

Via Electronic Submission

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

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

Dear Ms. Morris:

SUMMARY

The State of Utah supports the amendments to Regulation SHO that have been proposed by the SEC. While we believe that much more is necessary in order to regain public confidence in the integrity of U.S. capital markets, increase transparency and efficiency, and protect shareholders, we are nonetheless heartened by the attention paid to this issue by the SEC via the proposed changes to Regulation SHO.

Any claims by broker-dealers that elimination of grandfathering would be burdensome or costly are unjustified. No broker-dealer should assert any entitlement to an ability to fail to deliver securities that have been sold. This is especially true for sellers of threshold securities which have remained undelivered since 2004. There is no justification for failing to obtain and deliver securities outstanding for twenty months. The fact that 99% of the short positions in effect on January 5, 2005 have since been settled demonstrates that settlement can be accomplished.

Similarly, no holder of a short position used to hedge an open options position should claim he is entitled to maintain that uncovered short position after the corresponding options position has expired or been terminated. The exception for options market makers should be limited so that uncovered short positions are required to be settled promptly after the options position has expired. Once the options position expires, the short equity position becomes a speculative holding. The holder of that position has no right to expect to be excused from the duty imposed on all sellers – the duty to deliver securities sold.

The Utah Division of Securities urges the Commission not only to adopt these changes quickly, but to take all necessary additional steps to eliminate abusive short selling, delivery failures, and

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shareholder disenfranchisement. The comments below describe our concerns in more detail and suggest eight further steps the Commission should take to improve market integrity and enhance investor protection.

INTERESTS OF THE STATE OF UTAH

The State of Utah believes taking strong action to eliminate short selling abuses and reduce the frequency of delivery failures is necessary for three distinct reasons: market integrity, shareholder protection, and encouraging economic development.

1. Market Integrity

The capital markets are critical components of our economy. Fair, efficient markets are essential to the economic well-being of our citizens and the proper functioning of our economy. Free and efficient markets also contribute other benefits to the state and society. The Utah Constitution lists some of the benefits to society of free markets:

> It is the policy of the state of Utah that a free market system shall govern trade and commerce in this state to promote the dispersion of economic and political power and the general welfare of all the people.

UTAH CONST. art. XII, § 20.[1]

It is only if investors have confidence in the integrity of the markets that they are willing to invest their savings into the capital markets. This capital is the means of wealth creation, saving for retirement, and liquidity for those investors. Of equal import is that this capital enable businesses to open and expand their operations.

Utah learned a very hard lesson in the 1980's. At the time, there were some who believed that all securities business was valuable and welcome in the state. The rationalization was that regulatory efforts to distinguish between legitimate market participants and those brokers permitting manipulation were too burdensome on the markets. This resulted in Utah being used as the home base by penny stock promoters and broker-dealers pushing investments with more hype than substance.

Fortunately, the reality has changed. The state has since strengthened its laws and substantially increased its enforcement efforts directed at punishing securities fraud. In the past five years, the Division of Securities, working with criminal prosecutors, has filed criminal charges against more than 200 fraud promoters. Unfortunately, the state's reputation as a haven for illegitimate stock offerings has been slower to die. That reputation, so easily lost in the 1980's, takes substantial time and effort to rebuild.

[1] Although this quote is from the section of the Utah Constitution dealing with antitrust laws, the enunciated principles are equally applicable to the capital markets.

The same is true for the national markets. We offer our sad experience as a cautionary tale to those advocating for a regulatory regime that permits abusive market conduct to hide behind legitimate capital markets activities.

2. **Shareholder Protection**

Based on the importance of capital markets to our economy and the necessity of investor monies as a source of capital for those markets, it is ineluctable that investors need to have confidence in the markets. Investor confidence requires that investors be convinced of the absence of fraud, lack of manipulation of the markets, accuracy of information about market activities, fairness and equality of opportunity for all investors (large and small), and unwavering commitment of policy makers and regulators to protecting those investors.

Investor confidence can be shaken in any number of ways. Three, however, are of particular importance here. One is a reduction in general confidence in the integrity of the markets and in regulators when credible claims are published that short sellers are seeking to affect share prices artificially. If these types of claims are credible, they must be investigated and the results reported publicly. Otherwise, investors' faith in the markets is diminished. A second problem undermining investor confidence is more personal to the investor: when the shares purchased by the investor are not delivered on time or are not delivered at all. How can we expect investors to entrust their savings to a market that cannot deliver what is promised? A related concern is that investors who hold securities in a margin account at a broker-dealer may have those securities lent out by the broker-dealer and the investors are never told, nor do they receive any of the often sizeable compensation earned by the broker-dealer from the lending activities.[2]

We recognize that the fine print of the margin agreements signed by brokerage firm customers ordinarily does disclose that the customers' shares may be lent out by the brokerage firm. From a technical, legal point of view, the firms may be protecting themselves from any liability to the customers for this conduct. Our concern, however, is about the surprise and anger customers might feel were they to be aware fully of the extent of these practices (or worse, if a broker-dealer failed to replace shares it had borrowed or failed to ensure eventual delivery of shares that failed to settle on time). That surprise and anger will translate to reduced confidence in the fairness and integrity of the markets.

The third concern specific to abusive short selling and delivery failures is voting disenfranchisement. If a broker-dealer's customer has shares of a company in the customer's margin account and those shares are lent by the broker-dealer to another customer or another firm, the question arises: Who is entitled to vote those shares at the annual meeting or in a proxy contest? As noted above, the owner of those shares rarely is aware that the shares have been lent. If she were to be told that she could not vote those shares, the broker-dealer would be forced to reveal that the shares had been lent. Therefore, the prevailing practice in the industry is to permit the customer, whose shares were lent, still to vote those shares. However, those shares actually were sold to another buyer. In all likelihood, that buyer has no idea that the shares he

[2] We recognize that the broker-dealer has an obligation to replace those shares immediately if a customer decides to sell shares that have been lent. While this is an essential protection for the customer, the fact remains that customer shares were lent to another by the broker-dealer and only the broker-dealer receives compensation for that lending.

purchased were borrowed. That buyer expects to vote those shares. Indeed, that buyer is the rightful owner of those shares. If both the lending customer and the buyer vote their shares, there will be double voting of the same shares. On a broader market-wide basis, this could lead to significant overvoting.

In fact, overvoting is a significant problem in the market. An April 2006 news story reported that the Securities Transfer Association reviewed 341 shareholder votes in 2005 and found overvoting in every instance. Drummond, *Corporate Voting Charade*, Bloomberg Markets, Apr. 2006, p. 98. The Securities Transfer Association issued a white paper in December 2004 explaining that voting instructions are sent to parties who should not be authorized to vote and that this can result in votes being discounted and real owners unknowingly losing their voting power (or being ignored). www.stai.org/docs/treating_shareholders_equally.doc .

This practice, too, threatens to erode investor confidence if permitted to continue.

3. **Protecting Public Companies**

Economic development is a crucial element of the State of Utah's plan to improve the lives of its citizens. This requires an environment conducive to the growth of small businesses that one day may seek to go public in the capital markets. It also requires that we help ensure the integrity of the capital markets for those companies already publicly held.

The state is fortunate to be home to many public companies including SkyWest Airlines, Zions Bancorp, Franklin Covey, Huntsman Chemical, 1-800 Contacts, and Overstock.com. We owe a duty to these companies, to their employees, and to their shareholders to assist in making the capital markets as free from artificial influences as possible. To the extent that artificial influences or attempted manipulations distort market prices or increase selling pressure in contrived ways, those companies, employees, and shareholders – and the state's reputation – are harmed. Examples include purchasers of stock in these companies whose shares are not delivered at settlement; owners of stock whose shares have been lent and, therefore, their votes cast at the annual shareholder meeting are not counted; shareholders whose stock values may not accurately reflect the value of their holdings; and prospective purchasers of stock in these companies who may be reluctant to buy out of a fear that the stock price will be manipulated downward.

Failing to do our part for these shareholders, employees, and companies contributes to a decline in investor confidence in the markets.

UTAH'S INVESTIGATION HAS BEEN HAMPERED

Due to these concerns, Utah's Division of Securities has been attempting to investigate suspicions of delivery failures. However, efforts to discover the truth have been severely hampered by broker-dealers and the Depository Trust and Clearing Corp. (DTCC).

The Division requested information from ten of the largest broker-dealers early this year, seeking information about delivery failures and instances of buy-ins to cover short sales. The objective

was to identify 1) at which firms delivery failures were occurring, 2) whether those delivery failures were caused by either naked short selling or manipulative devices, and 3) if so, identify which customers were engaging in these tactics. The response from most firms was that they were complying with the requirements of Regulation SHO and that they were unable to determine which trades had failed to settle because the Continuous Net Settlement (CNS) system did not report that any particular customers had failed to deliver (*i.e.*, were short); CNS reported only the firm's overall daily net position. In addition, the firms told us that DTCC – as the contraparty to the firm's net trades – is the only entity that would know which firms had failed to settle their transactions and whether buy-in was demanded.

The state also sought information from DTCC. The Division of Securities asked for information that would allow it to determine which broker-dealers had demonstrated patterns of delivery failures and sought evidence of instances where DTCC had demanded that a broker-dealer "buy in" to resolve a delivery failure. Utah had every reason to expect the full cooperation of DTCC in the prompt resolution of this issue. To Utah's dismay, DTCC's response was, and remains, obstructionist. Initially, DTCC objected to the request, saying that the information it had was protected from disclosure, based on privacy concerns. The state pointed out that those settlement records reflected trades conducted by firms that are subject to examination by the Utah Division of Securities. So, if DTCC refused to cooperate in the Division's efforts to investigate suspected manipulation, the Division would have to require that each firm obtain the information from DTCC and the state would have to expend significantly more effort to analyze the information. Moreover, the Division expressed grave concern about the prospect of broker-dealers hiding records needed for an investigation by giving exclusive control over such records to an entity, such as DTCC, that refuses access to regulators.

The Division then asked DTCC whether it would provide the requested information if the Division procured consents from DTCC participants for the release of the trading information. DTCC agreed. The Division then undertook an extensive effort and obtained consents from 1,451 broker-dealers to grant us access to their trading records at DTCC. Those consents were provided to DTCC on June 2, 2006. DTCC still has not provided the requested information. DTCC now has offered to provide us with one type of report – but only in hard-copy form, not in a searchable electronic form (even though DTCC keeps the information in electronic form). The Division does not know whether the obstreperous attitude of DTCC is because DTCC has shortcomings that it fears releasing or whether DTCC's lack of cooperation is at the behest of its participant firms.

UTAH LEGISLATION

The Utah legislature passed a law in May, 2006 requiring broker-dealers to report to the Division information about delivery failures, including information that would enable the Division to identify traders showing a history of selling securities and not delivering the shares by settlement day.

The Securities Industry Association filed suit in July, seeking to enjoin enforcement of the law. The suit argued that Utah's law violated the preemptive provisions of the National Securities Markets Improvement Act, which requires the states to defer to the SEC on most broker-dealer

recordkeeping and reporting requirements. The state stipulated to an injunction against enforcement of the law, to await the results of the SEC's current rulemaking process and to give the securities industry an opportunity to work with the legislature to find other solutions to the problem of abusive trading.

If the states are to be preempted from imposing additional recordkeeping requirements, the SEC must assume greater responsibility for protecting investors by ensuring transparency and fair market practices by short sellers. Market integrity will be compromised if the SEC maintains exclusive access to the data necessary to investigate abuses – then fails to ensure that all abuses are eliminated.

LEGITIMATE USES OF SHORT SELLING

While the state has grave concerns about manipulative short selling and market problems that flow from such trading, we do not believe that short selling is inherently malicious or detrimental to the market. Market integrity and its corollary, investor confidence, require that the market provide selling opportunities for those believing prices will drop as well as buying opportunities for the optimists. Similarly, we recognize that there are understandable reasons that trades may fail to settle by the settlement date. Many of these settlement failures are not due to improper conduct by firms and no sanction is needed to motivate future compliance.

However, the fact that some short selling practices are legitimate and that some settlement failures have understandable causes should not be used to justify or ignore the manipulative, artificial, or abusive practices that can occur with short selling. Indeed, we believe that some traders – and perhaps some broker-dealers – are using the legitimate strategy of short selling to disguise their manipulative conduct.

Ironically, some of abusive trading occurs as a result of the requirements of Regulation SHO. For example, the public disclosure of which companies' stocks have sufficiently high numbers of settlement failures to put the company on a threshold list can itself cause a company to be targeted by short sellers. An increase in options trading also may occur, magnifying selling pressure. This added options activity also can exacerbate delivery failures. Thus, the very practice that is intended to increase transparency and make manipulation more difficult may induce increased short interest in the company (*i.e.*, selling pressure).

MALEVOLENCE HIDING BEHIND LEGITIMATE CONDUCT

While the state readily acknowledges the legitimate role of short selling, we also must expect accountability for those engaging in illegitimate conduct which masquerades as legitimate short selling. That accountability must be demanded by regulators. Just as regulators have a duty to prevent manipulation of share prices upward, they should detect and prevent the mirror image – manipulative devices that push share prices downward. These devices include naked short selling, the existence of substantial open fail positions, collusion between traders and analysts as

to the content and timing for release of research reports, and the depressive effect on prices of multiplicity (having multiples of shares available for sale).[3]

Regulators must recognize that processes designed to facilitate and accelerate the settlement of trades can contribute to manipulative devices. The dematerialization of securities, while it has been of incalculable benefit in facilitating settlement, makes multiplicity possible. Since shares are no longer distinguished by certificates, it is easier to inflate the number of shares available for sale, thereby creating downward pressure on stock prices. In fact, most abusive short selling could not succeed without dematerialization.[4]

The CNS system also facilitates the concealment of abusive short selling. Because a particular broker-dealer's buy orders and sell orders are offset before being settled by DTCC (called net settlement), a short seller's failure to deliver shares can be concealed by the existence of offsetting long transactions at the same broker-dealer. The result is that the DTCC never would know that there was an outstanding delivery failure; the naked short position would be covered up by long transactions at the same firm.[5]

To the extent that broker-dealers trade securities between them which are not reflected on an exchange and are not cleared through DTCC ("ex-clearing"), multiplicity can occur if the buying firm fails to demand that the selling firm deliver shares sold. In such a situation, the buying firm may worry that it will be in the opposite position in the future and does not want the other firm to demand that it deliver. Instead, the firms may agree to let the delivery failure slide.

The fact that some trades fail to settle on time is understandable. But, those settlement failures should be rare and should be resolved within days. Just because regulators accept that some transactions will not settle on the designated settlement date does not justify large numbers of outstanding delivery failures or having delivery failures extend over multiple weeks or months. Grandfathering should be eliminated to prevent the possibility of extended and voluminous fails.

The potential problems caused by abusive trading – masquerading as legitimate trading – are legion:

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[3] An example would be when a seller sells shares, but does not deliver them. The buyer's account will be credited with the shares, even though the shares have not been delivered. DTCC (or its subsidiary, NSCC) may well borrow shares to cover the delivery failure, but the number of shares available to sell still has increased. Because DTCC is "borrowing" the shares, not "buying in" the shares, there has not been an offset to (or reconciliation of) the delivery failure. The lender of shares to DTCC still is the actual owner of the shares and could withdraw those lent shares and sell them. The buyer of the stock does not know there has been a delivery failure and can sell the stock he bought (but did not receive). Thus, the same block of stock has now been doubled for purposes of affecting the supply of the stock (even though this has not affected the actual number of shares issued by the company).

[4] Dematerialization has become an unintended contributor to the problem of overvoting. By lending shares that are then sold, and lent again, there can be multiple owners all thinking they are the owners of the same shares – and entitled to vote those shares. As discussed above, when the votes are tallied, some votes cast by legitimate owners will be discounted or disregarded.

[5] In such an instance, it is the buying customers at that broker-dealer who are being harmed. They are not receiving delivery of their purchases (although they may not know it). Those purchasers a) have not received delivery of their shares, b) should not be entitled to vote the shares purchased, and c) have unwittingly contributed to multiplicity.

- Higher settlement failures. The number, volume, and length of settlement failures are increased because of the trading activities of short sellers.

- Lack of disclosure. Customers may complain that they are not aware of the extent to which their shares are being lent out and the effects on customers of the lending. Some also may complain that they are not receiving any portion of the compensation the brokerage firm is earning by lending out the customers' stockholdings. When this happens, the customer no longer has equity ownership; he only has an I.O.U. The customer also loses his voting rights.

- Shareholder voting rights are impaired. This impairment can include overvoting as well as possible customer complaints that they are not being informed of the risks their votes will not be counted. It could be argued that broker-dealers affirmatively are misleading customers if the firms provide proxy voting information to customers when the customers' shares have been lent to another.

- Inaccurate recordkeeping. Individual customers rarely are informed when their shares have been lent by the broker-dealer. The secrecy of this practice is facilitated by the records of the broker-dealer which continue to show the customer as the owner of shares. When the customer receives her account statements, any shares that have been lent to another by the broker-dealer still are listed on the customer account statement as being in the customer account. This record is not accurate. If the shares have been lent, the customer is not the holder or owner of the shares.[6]

- Multiplicity. As described above, the number of shares represented as available in the market may exceed the number of shares actually available to deliver. This magnifies the depressive effect of the asking prices for these shares. As described below, the extent by which the shares being offered exceed the number of shares outstanding can be enormous. Also, see the example described in note 21.

- Improper incentives. Short selling creates incentives for other violative or manipulative conduct. Regulation SHO, while it attempts to prevent short selling abuses, permits some conduct that can further abusive conduct. These incentives include:

    - *Insider trading*. Because short selling is profitable only if a company's stock price falls, traders have a significant incentive to learn – or create – negative information about a company, then advertise that information. Testimony at the June 28, 2006 hearing by the United States Senate Judiciary Committee, "*Hedge Funds and Independent Analysts: How Independent are Their Relationships?*" included allegations that some traders collude to have research firms release reports disparaging a company's performance, then time the release of those reports to occur after the trader has created a large short position.[7] These

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[6] Simultaneously, the buyer of the lent shares also receives an account statement showing that he owns these shares. Both customer account statements are recording ownership of the identical shares.

[7] Similar allegations are detailed in a news story. Anderson, *True or False: A Hedge Fund Plotted to Hurt a Drug Maker*, New York Times, Mar. 26, 2006 (found at www.nytimes.com/2006/03/26/business/yourmoney/26 gradient)

allegations are consistent with actual violations found by regulators. The Commission has brought several enforcement actions involving insider trading. In March 2006, three hedge funds and a manager were accused of insider trading and naked short selling in connection with 23 Private Investments in Public Equity (PIPE) offerings. *SEC v. Langley Partners*, SEC Lit. Rel. 19607, Mar. 14, 2006. In May, the SEC sued hedge fund adviser Deephaven Capital management for insider trading on advance knowledge that 19 PIPE offerings were about to be announced publicly. *SEC v. Deephaven Capital Management, LLC and Bruce Lieberman*, SEC Lit. Rel. No. 19683, May 2, 2006. In 2005, the manager of hedge fund Millennium Partners paid $1.45 million in fines and disgorgement and was barred from the securities industry for obtaining the right to buy 475,000 shares in a PIPE offering by Compudyne, then shorting 122,900 shares before the PIPE offering was announced publicly. Enforcement actions were brought by the SEC and NASD. *SEC v. Hilary L. Shane*, SEC Lit. Rel. No. 19227, May 18, 2005.

- *Bear raids*. There are many examples of companies who have sought financing only to have the financiers try to drive the stock price *down*. Such financings involve the company guaranteeing the value of convertible debt by promising to deliver additional stock if the company's stock price drops below certain levels, while the lenders actively seek to cause that very result. These types of financings may be PIPEs or convertible debt (also called – generally after the fact – death spiral financing or toxic convertibles). Some lenders short the stock of the company to which they provide financing in an effort to cause declines in the stock's price and to then profit from those declines. The lender ends up with cash profits and more stock. This was the conduct underlying the SEC's 2003 action against Rhino Advisors. In that case, Rhino is alleged to have manipulated the stock price of Sedona Corp. based on debenture contract terms that provided that the lower Sedona's stock price, the more shares the client would receive when the debenture was converted. Rhino engaged in extensive short selling of Sedona stock on behalf of a client, in direct violation of an agreement with Sedona. Rhino and its president were enjoined and paid a $1 million fine. *SEC v. Rhino Advisor, Inc. and Thomas Badian*, Lit. Rel. No. 18003, Feb. 27, 2003. See also, Emshwiller, *Lawyer Tied to Past Small-Stock Scam Takes Up Contentious 'PIPE' Deals*, Wall St. J., Aug. 25, 2006 at C-1.

- *Naked short selling*. Short selling can be risky. The profit margin to be earned can be substantially reduced or even completely offset by the costs of borrowing stocks. The costs can be significant, reportedly as much as 23% of the value of a security for certain "hard-to-borrow" stocks. Short sellers who avoid borrowing stocks before selling them (and avoid delivering them at settlement) can save these costs, increasing their profit margins.[8] Two lawsuits have been filed in New

[8] As discussed above, the lack of cooperation by DTCC hinders the Utah Division of Securities' ability to investigate traders and broker-dealers engaged in such conduct because of the Division's inability to discover what firms and customers have patterns of delivery failures and inability to identify those whose delivery failures are ongoing and voluminous, rather than transitory.

York accusing prime brokers of, *inter alia*, charging stock lending fees for stock that never was lent. Moyer, *Hedge Fund Hell*, Forbes.com, July 28, 2006.

- *Inadequate locates*. Regulation SHO only requires a short seller to "locate" shares that can be borrowed. The seller is not required to "reserve" (*i.e.*, have the lender decrement) the shares located and nothing precludes a lender from giving a "locate" on the same shares to multiple sellers. This can lead to an increase in settlement fails if multiple sellers rely on the same locate and some then are unable to actually borrow those shares. In such a situation, Regulation SHO is not violated and the lender and "locator" have not acted improperly. This conduct, that increases the number of fails, should not be permitted. Inadequate locates also can come from customers. Because Regulation SHO permits customers to obtain the "locates" on shares to be sold short,[9] customers are tempted to act on their economic incentive to avoid the costs of actually borrowing shares. Regulatory action taken against Goldman Sachs and Credit Suisse on July 24, 2006 was based, in part, on the firms' failures to obtain locates for client short sales or failing to ensure that locates provided by customers were reasonable.[10]

- *Manipulation*. The insider trading, naked short selling, delivery failures, and bear-raid activities described above all are forms of market manipulation. The frequency and magnitude of these abuses are exacerbated by short selling, especially given the volume of trading by short sellers and hedge funds (discussed below). The SEC's civil suit alleging collusion between Refco brokers and Pond Securities to engage in short selling to manipulate downward the price of Sedona Corp. stock is an example of the type of manipulation that can occur. *SEC v. Andreas Badian, et al.*, Lit. Rel. No. 19639, Apr. 4, 2006.

- *Uptick abuses*. We fear that traders may avoid the uptick rule by having another broker enter an accommodating trade for 100 shares at an uptick price, thus permitting the trader to enter an order for a short sale of 100,000 shares.

- *Mismarking trades*. Too many firms report inaccurate information about short transactions. Due to the significant economic benefits that can be derived from abusive short selling, we suspect that the failure of some firms to mark short sale transactions accurately is intentional, not accidental. Whether intentional or accidental, these reporting errors are significant and can affect the accuracy of public information dramatically. These include a $400,000 fine against Lehman Brothers for inaccurately reporting short interest 41 times the actual amount;[11]

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[9] Regulation SHO requires that a broker-dealer's reliance on a "locate" by its customer must be reasonable.

[10] *NYSE Regulation Fines Four Firms $1.25 Million for Violation of SEC Rules on Short Sales*, NYSE Press Release, July 24, 2006 (found at www.nyse.com/press/1153476520386.html). Goldman was alleged to have failed to monitor customer short sales to determine whether it was reasonable to rely on customer locates. Credit Suisse is alleged to have failed to obtain locates for certain client trades.

[11] Lehman inaccurately reported to the NYSE short interest of 26,089,923 shares of a company when the correct figure was 625,360. The firm had incorrectly designated the shares into the wrong short and long account types when unwinding a swap transaction. This and other erroneous reports were made during a three-and-a-half year

$1,000,000 in fines against Daiwa Securities America, Goldman Sachs, and Citigroup for failing to correctly mark orders as long or short and not accurately reporting total fails;[12] and a $400,000 fine and 90-day suspension of a Citigroup broker for marking 100 short sales as long because the broker could not find any borrowable stock.[13] More needs to be done to ensure that brokerage firms accurately report the short selling activities of their clients. This will promote investor confidence in the integrity of the markets and enhance the accuracy and transparency of market information.[14]

- *Avoiding threshold designation*. We are concerned that some traders seek to hide their short selling activities, making great efforts to ensure their transactions do not trigger threshold designations. This might be done by having their fails not extend past five days after settlement or focusing on trades involving fewer than 10,000 shares or volumes less than .5% of the issuer's number of outstanding shares. Traders also recognize that they can execute short sale transactions (and any resulting settlement failures) that cause a company to be listed as a threshold security, without being subject to the consequences of the settlement failure: the trades would not be required to be closed out under Regulation SHO.

- *Market makers*. Market makers have incentives to facilitate non-market making trades under the guise of market making. This may include proprietary trading by the market maker, speculative trading strategies by customers, and otherwise assisting customers in avoiding the requirements of Regulation SHO.

- IPO shorting. The May 2006 IPO by Vonage Holdings Corp. revealed a threat few thought existed – the shorting of IPO shares. There was heavy short selling of Vonage stock on its first day of trading on the NYSE. Vonage shares have had high rates of delivery failures and have been included on "hard to borrow" lists since the company's IPO.[15] Regulators and the public rightly should question how short sellers could have located or borrowed stock necessary to short a company's IPO. It is essential to market integrity and investor confidence that initial public offerings be sold in an environment that precludes the possibility of naked short selling and that ensures the delivery of shares purchased by the customers.

If short selling is to be permitted, regulators must do more to combat these negative effects.

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period and "materially impacted the NYSE's overall short interest reporting . . . ." NYSE Hearing Panel Decision 06-53, *Lehman Brothers Inc.*, Apr. 18, 2006.

[12] *NYSE Regulation Fines Four Firms $1.25 Million for Violation of SEC Rules on Short Sales*, NYSE Press Release, July 24, 2006 (found at www.nyse.com/press/1153476520386.html). Daiwa was fined $400,000 for failing to mark proprietary trades as long or short and improperly calculating its net positions. Goldman paid a $350,000 fine for failing to ensure that orders properly were marked as long or short and for failing to combine its net positions at DTC. Citigroup's fine of $250,000 was for conduct including failing to combine its fails on two different accounts it maintained at DTC.

[13] *NASD Suspends Broker for 90 Days, Imposes Fine and Disgorgement Totaling $400,000 for Short Sale Violations*, NASD News Release, Apr. 26, 2006.

[14] We applaud the Commission, the NYSE, and the NASD for the enforcement actions they have taken recently and for placing a higher priority on investigations of these types of violations.

[15] Smith, *Suits Focus on Street's Role in 'Naked Shorting'*, Wall St. J., June 28, 2006 at C-1.

THE IMPACT OF STOCK LENDING AND HEDGE FUND TRADING ON THE MARKETS

The volume of stock lending is enormous. Wall Street firms earn $10 billion to $12 billion annually in fees. Moyer, *Hedge Fund Hell*, Forbes.com, July 28, 2006. Most of these fees come from hedge funds that not only pay huge fees to borrow shares from broker-dealers but also pay the firms commissions on securities transactions. Hedge fund trading is estimated to make up 30% of the daily volume of business for broker-dealers. *Id.*

Hedge funds are responsible for one-quarter to one half of all trading on the New York Stock Exchange. Anderson, *True or False: A Hedge Fund Plotted to Hurt a Drug Maker?* New York Times, Mar. 26. 2006 (found at www.nytimes.com/2006/03/26/business/yourmoney). This volume, along with the accompanying commissions being paid to broker-dealers, gives these hedge fund customers substantial power. Trading of such volume easily could be used to manipulate markets, especially when used for short selling or when the sellers fail to deliver securities at settlement.

There are some 9,000 hedge funds controlling almost $1 trillion in assets. Their volatile, high-risk trading strategies greatly influence our financial markets. Beck, *Hedge Funds Need Oversight*, Associated Press, June 29, 2006 (found at www.forbes.com/business/feeds/ap/2006/06/29/ap2849664.html).[16]

Because broker-dealers receive so much income from stock lending and securities execution for these funds, broker-dealers cannot be entrusted with the responsibility to ensure that these funds avoid manipulative or abusive trading. Market integrity can be maintained only if government regulators check the power exercised by these funds.

PROGRESS TO DATE

We commend the Commission for the steps that have been taken to improve disclosure and transparency relating to short selling abuses and for beginning the process of reducing the ability of broker-dealers and traders to engage in the abusive practices described above.

The positive steps that have been taken include:

- Extending Short Sale Limitations to OTC Stocks. Approval of NASD's new Rule 3210, extending Regulation SHO's requirements to trading of OTC stocks, is a beneficial step. We agree that abusive practices should be targeted for elimination in all markets, not just those markets trading large-cap stocks. Indeed, small-cap stocks often are more susceptible of manipulation so it is important that the protections of Regulation SHO also apply to these stocks. We applaud NASD for taking this step. NASD Notice to Members 06-28, June 2006.

[16] One third of these assets are concentrated in the top t10% of hedge funds. The top four control over $20 billion each. HedgeFund Intelligence Press Release, *Top U.S. Hedge Fund Assets Near $1 Trillion*, Sept. 5, 2006 (found at www.hedgefundintelligence.com/press/billiondollarhedgefundclub_2006 survey.pdf).

- Most Trades Settle. The Proposing Release notes that 99% of all trades (by dollar value) do settle on time, leaving approximately 1% that fail to settle by the deadline.[17] Further, the release notes that the vast majority of the remaining 1% is closed out within five days after the missed settlement date. It is a positive step that so many trades do settle quickly.

- Regulation SHO. Regulation SHO has had some effect on the frequency of settlement failures and abusive short selling. According to Commission statistics, the first 18 months after the adoption of Regulation SHO saw:

  - A decline of 34% in the average aggregate fails to deliver;

  - A decline of 6.5% of the average daily number of securities having aggregate fails of at least 10,000 shares;

  - The average age of a fail position has been reduced by 13.4%; and

  - The average daily number of threshold securities has dropped by 38.2%.[18]

Unfortunately, any positive effects attributable to Regulation SHO now have stalled. We have witnessed recent spikes in the average daily number of securities included on the threshold lists. Although the average number declined from 424 in January 2005 to 270.7 in November 2005, that number has since increased. Four of the six months following that November low point have seen increases over the prior month's average.[19]

MUCH MORE NEEDS TO BE DONE

Progress to Date is Unsatisfactory. While there has been some progress brought about by Regulation SHO, we must remember that any designation of a threshold security represents a market failure and any trade that fails to settle on time reflects an inefficiency – if not an attempted artifice.

We recognize that there are many reasons for a fail to deliver and that some of those reasons are understandable.[20] But, we believe that too many abusive sellers are attempting to hide behind the fact that some fails are acceptable. It is important that regulators and the market not excuse all settlement failures simply because a small minority of settlement failures occurs for understandable reasons. Until regulators and the market know how many of these fails result from abusive short selling, they must be suspicious of all fails. Indeed, regulators and clearing agencies have a duty to distinguish between fails for understandable reasons (all of which should close out within days) and fails resulting from abusive trading. The first type represents market

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[17] SEC Proposed Amendments to Regulation SHO, Rel. No. 34-54154, File No. S7-12-06, July 19, 2006 ("Proposing Release") at note 3.

[18] Memorandum, SEC Office of Economic Analysis, Aug. 21, 2006 at 1 (found at www.sec.gov/spotlight/failstodeliver082106.pdf). This information also is included in the proposing release, at note 18.

[19] Memorandum, SEC Office of Economic Analysis, at Table 2.

[20] Proposing Release at note 4.

inefficiencies; the second represents market failures. Fails resulting from abusive trading must be investigated immediately in order to identify the broker-dealers executing the trades and the customers for whose accounts the trades were entered.[21]

We believe that the clearing agencies derive too much comfort from the claim that 99% of trades are settled successfully. We must demand that our financial markets – the core of our economic system – have a 100% success rate. The public would not find it acceptable if only 1% of the nation's airline flights crashed in a day. The knowledge that 99% of buildings would not collapse during normal use would not be of comfort to people using those buildings. If citizens thought that one out of every hundred automobile trips would result in an accident or injury, there would be deafening calls for improvement. If a worker's personal computer failed to save 1% of documents created or failed to transmit 1% of e-mails sent, the uncertainty would create havoc for businesses needing assurances that information has been delivered. The same should be true of our clearing and settlement systems. The public should expect a much higher success rate.

There should be no threshold securities. To be designated a threshold security means that trading in an issuer's stock has resulted in over 10,000 unresolved fails and that this extends for more than five days. This problem can and must be prevented.

The numbers remain alarming. Since the adoption of Regulation SHO, each trading day finds an average of 312 companies with their stocks on the threshold list. Together, these companies had an average of 1,346 fail positions. The fail positions represent 189,000,000 shares.[22] This means that each day has, on average, 189,000,000 shares that have failed to settle properly. What happens to the buyers of these 189,000,000 shares is important and cannot be minimized. If those trades are being "busted," those buyers and sellers have not received the result they bargained for. If the clearing agencies have proceeded to execute those trades, using DTCC's stock borrow program as "cover" for the settlement, these 189,000,000 shares are artificially expanding the number of shares available for sale in the market. As noted above, the buyers of these shares can sell them and the owners of the shares lent to DTCC can withdraw the lent shares and sell them.

Incredibly, six companies have had their securities on the threshold list every trading day since the implementation of Regulation SHO. We do not see how this could not be viewed by the markets and by regulators as an indication that the markets are failing to fulfill the most basic of

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[21] A dramatic illustration of this principle is the company Global Links. If the news account is accurate, this company had settlement failures in February 2005 "that were 27 times greater than the total number of shares Global Links had issued at the time." Moyer, *Naked Horror*, Forbes.com, Aug. 25, 2006. Found at www.forbes.com/2006/08/25/naked-shorts-global-links . We note that if the February 2005 settlement failures information was accurate, the reverse stock split by Global Links appears to have resolved the high number of fails. As of July 25, 2006, less than 1% of the company's stock was reportedly sold short. Remond, *In The Money: OTC Short Data Don't Back Abuse Claims*, Dow Jones Newswire, Aug. 1, 2006.

The fact that there are some acceptable reasons for settlement failures should not even be mentioned in the face of massive settlement failures such as this. If regulators and the markets cannot and do not segregate fails resulting from abusive trading from fails with understandable causes, there should be no mention of acceptable fails. To do otherwise aids abusive traders in hiding behind legitimate market conduct. Their conduct is not legitimate.

[22] Memorandum, SEC Office of Economic Analysis, at p. 1.

the responsibilities entrusted to them. The goal must be to have eliminate the very notion of threshold securities.

The solution may be additional rulemaking, improved clearing processes, and increased enforcement resources devoted to the problem. Suggestions for eliminating the need to have threshold listings are contained at the end of this letter. What is clear, however, is that the steps being taken currently are not adequate. This, in turn, fuels investor discontent and reduces the confidence that we need investors to have. The volume of complaints aired publicly about abusive short selling, settlement failures, multiplicity, overvoting, and abusive trading by hedge funds is an ominous warning that investor confidence is sagging.

RECOMMENDATIONS

SEC Proposal. The State of Utah strongly urges the Commission to adopt the modest proposal set forth in the Proposing Release.

- Elimination of Grandfathering. Any perceived need to "grandfather" outstanding fails that existed at the time Regulation SHO was adopted in January 2005 has long since ceased to exist. The intervening 20 months have given the traders and the markets ample time and daily opportunities to close out those prior fail positions. The fact that those positions have not all been closed out is an indication that the failure is deliberate, not borne out of concern about market disruptions.[23]

  Elimination of the grandfathering provision will serve several purposes. First, it will reduce the ability of traders to engage in abusive trading by refusing to close out open fail positions. Second, it will make it more difficult for a trader to engage in abusive trading by participating in trades that *cause* an issuer to be included on the threshold list, but not being subject to the close-out requirements for the securities of companies already on the list. As it stands currently, not only is there no punishment for failing to close out long-standing open positions, but a perverse incentive is created to cause a security to become a threshold security. Third, market integrity requires that these trades not be permitted to remain unresolved. Issuers must be the ones in control of how many shares of their stock are outstanding and tradable. Fourth, public investors should have every trade settled by delivery of the actual shares sold, not a settlement where DTCC has borrowed shares from someone not a party to the transaction. As the Proposing Release explains, shareholders should have the benefits of ownership, such as voting and lending.[24] Fifth, public confidence will increase as these longstanding unresolved fails are closed out.

  The Proposing Release indicates that the persistent and substantial fails for a small number of companies are attributable to the grandfather provision and the options market maker exception. Proposing Release at p. 8. If so, the proposed changes should cause an

[23] The fact that 99.2% of fails that existed on January 3, 2005 have been closed out is encouraging. Proposing Release at note 22. The fact that almost 1% of settlement failures from transactions executed more than 20 months ago still have not been closed out, however, is alarming.
[24] Proposing Release at p. 8.

even more dramatic drop in the number of threshold securities and the volume of outstanding fails.

Additional comments on questions posed by the SEC's release are:

- *No phase-in period is necessary*. Fails that occurred before January 3, 2005 should not be given an extended period of time to be closed out. Twenty months have elapsed. That is far more than necessary to effectuate any close-out. There should be no phase-in period. The lengthy process of proposing these rule changes and announcing the effective date of rule changes will give these market participants abundant opportunity to close out trades that should have been closed out a year and a half ago. Additional time would only encourage additional speculation or further manipulation.

- *Triggering transactions do not deserve additional time for close out*. Fails that occur *before* a security becomes a threshold security should not be given additional time for close-out. The customers participating in those transactions deserve finality and delivery for their transactions. If broker-dealers or traders are concerned about their ability to borrow shares before settlement, they can protect themselves by borrowing shares in advance of the sell order. Giving additional time to close out those trades would reward those who have not taken responsible steps to avoid these risks. Neither regulators nor the markets should be in the business of protecting speculators against market risk willingly undertaken by the speculators.

- *Harm caused by persistent grandfathered fails*. We believe that persistent grandfathered fails to deliver cause serious harm to the securities of issuers included on the threshold list. These include harms to shareholders, issuers, the integrity of the markets, and, more broadly, investor confidence in the integrity of our financial markets.

- *13-day limit should be shortened*. Given the severe deleterious effects on the markets caused by open fail positions, the close-out requirements should be triggered by very short time deadlines. The current 13-day limit is far too long. Imposing a limit of ten days is preferable, but still too generous. Since the vast majority of failed settlements are closed out within five days after settlement, it appears that five additional days should be more than sufficient to close out fails. Penalties should be imposed for fails that extend beyond five days.[25] We are concerned that the Commission places too much emphasis on the potential impact on a *trader* who must close out a failed settlement. The better approach in to focus on the interests of buyers and the markets. It is important to understand that closing out a failed settlement is only one solution. We believe that a much better solution is a requirement that the broker-dealer not enter a short trade before being certain that the firm will have the necessary securities to accomplish

[25] Just as the Commission has pushed to improve market efficiency by moving settlement from T+5, it should press to shorten settlement deadlines in closing open fail positions.

settlement. A shorter time frame for closing out positions will not only encourage firms to be more vigilant about their "locates," but also will have the effect of providing for more conscientious pre-borrowing conduct. Put another way, the Commission should not be preoccupied with easing the burden on firms to close out fails when 1) the fail occurred because the firm has failed to do what it is obligated to do – deliver a security, and 2) the firm could avoid any market risk from close-out by ensuring it has the securities to effectuate the settlement.

- *Grandfathering should be eliminated for all fails*. The elimination of grandfathering should *not* be restricted only to those securities where the highest levels of fails exist. If regulators will acknowledge that the existence of any fails or any threshold listings reveals market defects, as they must, then they also will recognize that more must be done to reduce the number of fails and the number of threshold securities. This means that the elimination of grandfathering cannot be restricted to only the most active targets of short sellers. To do so would place regulators in the position of creating artificial incentives and disincentives; these, in turn, are likely to persuade traders to focus their short selling strategies on companies where grandfathering rights still exist.

- *No de minimis exemption.* For the same reasons, there should not be a *de minimis* number of fails that would not be subject to a mandatory close out. Three additional reasons illustrate why a *de minimis* exemption is undesirable. *First*, if the number of fails is *de minimis*, the reason for granting additional time for close out ceases to exist. An extended close-out period was permitted originally to avoid market disruptions and short squeezes that might occur when a trader had to buy in securities to close out a position. If the amount of securities to be bought in is small, there should be no concern about market disruption. *Second*, having a *de minimis* cutoff would be expected to increase compliance and operational costs for broker-dealers. Having a uniform rule applicable to all close outs would be the best and most obvious means of limiting the compliance and oversight costs of firms. *Third*, investor confidence would be highest with a uniform close-out rule. Investors would not think that traders still had an opportunity to avoid closing out a position. Issuers would not worry that their securities were being traded, but not settled. These issuers intending to seek additional funding would better be able to receive prices for secondary offerings that are reflective of an efficient market. Further reduction in the number of reasons issuers and investors have to be suspicious should itself be sufficient to eliminate any disparate treatment of close out obligations.

- *Relief for trading errors is not warranted.* The Commission should *not* consider granting relief to allow market participants to close out fails in threshold securities due to trading errors. The cost of closing out a fail should be part of the economic cost of making a trading error. Should such an error occur, the firm still has the option of borrowing shares to fulfill its settlement obligation. The firm then can replace those borrowed shares in a phased manner that would reduce the market (and economic) impact of the error. Moreover, the Commission should not offer

relief in settling errors arising from short transactions when such relief is not offered in long transactions. If a broker-dealer executed a long transaction that mistakenly multiplied the order ten fold, the Commission would not relieve the firm of the obligation to pay for the purchase (or prolong the payment obligation 30 or 60 days), just because it was an error.[26]

- *Rule 144 securities*. Fails resulting from delays in removing legend restrictions on Rule 144 stock are in a different category than fails that might be related to abusive trading. Nevertheless, the harm can be the same. Our view is that a seller of stock subject to a Rule 144 restriction should bear the burden of being prepared to tender unrestricted stock at the time of settlement. This can be done by anticipating the sale sufficiently in advance to have the restriction removed. Alternatively, if unrestricted shares cannot be delivered on time, the seller can borrow shares before the settlement date to fulfill its duties to the buyer. Given that most Rule 144 sellers are insiders who have received their stocks at very low prices, it is both fair and in the interests of ensuring market integrity and confidence to expect them to bear the cost of borrowing shares until delivery of unrestricted stock. Holders of Rule 144 stock should be "bought in" if they cannot deliver shares that are in "good order."

- *Triggers for threshold determination*. The current parameters for the definition of a threshold security are too high. The lower the triggers, the higher investor confidence will be. Currently, there are no sanctions against a broker-dealer that causes fails below the 10,000 share/0.5% trigger (or fails higher than that but before listing as a threshold security) and fails to settle. The Commission's goal should be to eliminate as many settlement failures as possible. That is done by lowering the triggers for a threshold listing. A step towards their goal would be to halve the share volume and percentage triggers.

- *Customer account-level close out should be required*. We believe that firms should be required to track the accounts responsible for fails. It is unimaginable that a firm would not track which customers failed to pay for securities the customer purchased through the firm. In that instance, the firm would be obligated to pay, even if the customer did not. The aggressiveness of firms in demanding payment or selling out a customer's holdings to ensure payment is well known. We cannot understand, then, why a firm would not be able, and should not be required, to track when customers have failed to perform their obligations on the other side of the transaction. Indeed, firms should be required to: 1) track the accounts responsible for the fails,[27] 2) keep a log of those accounts which would be available for the inspection of regulators, 3) buy in (or borrow)

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[26] Consideration is not typically given to customers who execute their own orders and make errors. They are responsible for any losses. Ergo, trading professionals, who are much more knowledgeable, should be responsible for errors they make.

[27] *C.f.*, NASD Rule 3360 was amended earlier this year to require member firms to report to the NASD the firm's total short position twice monthly. Firms already were required to maintain a record of total short positions in all customer and proprietary accounts. SEC Rel. No. 34-53224 (Feb. 3, 2006). A broker-dealer's report of total short positions necessarily would be an aggregate of short positions in individual accounts.

securities sufficient to cover the customer's failure to deliver within five days after the settlement failure,[28] 4) refuse to permit any future short sales premised on a "locate" provided by that customer, 5) conduct an internal review to determine whether the customer's trading patterns reflect abusive or manipulative trading and whether the firm has been an instrument in such trading (if so, the firm should be required to prohibit any future short selling by that customer), 6) implement policies and procedures for handling client accounts and identifying, for regulators and the markets, those clients who repeatedly fail to deliver.

- *Mandatory pre-borrowing should be required for all firms trading in threshold securities having extended fails*. If securities included in the threshold list have extended fails to deliver, all firms shorting those securities should be required to pre-borrow shares. If particular securities have significant levels of outstanding fails, the harm to market integrity and customer protection is not reduced because additional fails are caused by different firms than the ones creating the existing backlog.[29] Again, we emphasize our view that any threshold designation and any settlement failure is *per se* evidence of a market deficiency. Every effort must be made to reduce those events. When a significant level of fails already has manifested, all market participants have a heightened duty to ameliorate the problem, not exacerbate it. *Any listing of a security on the threshold list should require pre borrowing for all short sales of that security while the threshold listing is in effect. Once a security makes the threshold list all sellers should be required to borrow, not just locate.* In addition, we believe that every market participant has a "gatekeeper" duty to the markets and to investors generally. All firms must ensure that their customers engage in only fair and lawful transactions. This includes a duty to require that customers deliver securities at settlement (without regard to whether other customers at the firm have failed to deliver those same securities or whether other customers at other firms have failed to deliver). Finally, applying the pre-borrow requirement to all traders of these securities eliminates the ability of firms to avoid a close-out or delivery obligation by transferring the obligation to another broker-dealer whose trades have not triggered the close-out requirement.

- *Multiple sales relying on the same "locate"*. Sellers can no longer be permitted to use a single locate for multiple short sales. As we understand it, the purpose behind the Commission's decision to allow locates rather than require pre-borrowing was to facilitate the ability of traders to execute trades quickly, rather than risking market movements during the time it would take to actually borrow shares. Unfortunately, this decision has led to egregious, routine abuses. When firms use a single locate to justify multiple trades or when a stock lender provides

[28] If a firm permits short selling, the firm is in a position to protect itself from defalcations by such customers. If the firm provides the locate, the firm has the obligation to borrow shares to effect delivery at settlement. If the firm relies on the customer to provide the locate, the firm must either assume the risk of non-delivery by the customer or ensure that adequate security exists to compensate the firm for borrowing or buying in shares.

[29] A rough analogy is where an oil company's negligence results in an oil spill. Enhanced safety procedures implemented to ensure that such a mistake not recur should apply to all companies transporting oil in that market, not just those whose negligence caused the first spill.

multiple locates on the same supply of shares, both the system and market participants are being abused. This likely is a cause of a significant number of settlement failures.[30] Rule 203(b)(1) should be amended to provide for stricter locates by requiring that stock lenders decrement shares. We expect that taking this action would 1) reduce the potential for fails, 2) increase transparency in the stock lending market by providing a clearer picture of how many shares of each security truly are available for lending, 3) impose market discipline by encouraging traders to consider, before entering a trade, the likelihood that the locate will result in a delivery, 4) decrease short squeezes, and 5) reduce the problem of multiplicity and overvoting (by reducing the number of fails that are settled using DTCC's stock-borrow program).

- *The impact on liquidity of stricter locate requirements*. The Proposing Release asks: "Would requiring stricter locate requirements reduce liquidity?" This question deserves serious rethinking. This question might properly be reconsidered as follows: "Should we justify settlement failures (with the resulting multiplicity and overvoting) as a means of providing more liquidity to securities that are hard to borrow or that are issued by smaller companies?" The answer to the rephrased question is a resounding NO. In a competitive, transparent market, liquidity is a function of price. Liquidity is nothing more than supply. The higher the price, the larger the number of shares that will be available. Therefore, to permit firms or the market to increase liquidity artificially, by the elimination of a delivery requirement for shares sold would cause a corresponding injurious change in the demand (*i.e.*, price). *Liquidity should be determined by the market through bidding and offering, not through the artifice of selling securities where there will be no delivery and then excusing the sellers who fails to satisfy their delivery obligations. An increase in the number of shares available results in higher trading volume by market makers. Neither regulators nor the markets should be in the business of creating additional business for market makers. Rather, the duty is to ensure that markets properly reflect supply and demand for a given security – and most assist in creating the extra shares needed to meet demand at artificial prices that might be set by a market maker. If more shares are needed in the market, let the issuer issue the shares and reap the benefits of the secondary offering.*

- *Disclosure of aggregate fail positions should be required*. Given that Regulation SHO has not eliminated the problem of abusive short selling or the backlog of unresolved fails, more must be done. Public disclosure of broker dealer failures to deliver securities would help achieve those goals. The primary justifications commonly given for permitting additional time to settle short sales and to keep short sale information secret have been desires to prevent short squeezes and reduce market volatility. We believe that permitting those two results to come to pass would provide the motivation needed to avoid abuses that currently roil the markets. Any risks of market volatility and short squeezes would be of concern

[30] We are not aware whether the Commission has studied the extent to which fails are caused by "overbooking" of locates.

primarily to those with uncovered positions. *If we were to choose between the risk of customers not receiving shares they have purchased (along with the related consequences of delivery failures) and the risk that traders might be the subject of a short squeeze, we will choose the latter. Traders are in a much better position to protect themselves than the investors who have relied on market participants to execute their orders.* The fear of being a victim of a short squeeze or the possibility that volatility will make it more expensive to cover a short position are the "natural consequences" of the conduct of these traders. To the extent that the current regulations protect traders from the risks and attendant consequences of short selling conduct, the regulations encourage abusive conduct. Short squeezes would be an effective punishment for sellers who have failed to deliver on contracts they have made. Volatility is the market's natural and proper response to uncertainty regarding secret conduct of short sellers. Disclosure of aggregate positions should be required, even if the result involves an increase in volatility or short squeezes. An additional benefit would be that this information would assist regulators in identifying abusers and bring more accountability to the market. As further regards such disclosures:

- These disclosures should be on an individual stock basis.

- Disclosure should be required by broker-dealers, the SROs and the DTCC. Disclosure at these three levels accomplishes important objectives. First, it provides a confidence-building check on the accuracy of the information being provided by others.[31] If the SROs reports aggregate fails for a company totaling X and together the broker-dealers only report a total of half of X, regulators and the market will know that not all broker-dealers are reporting fails accurately.[32] Second, this reporting will aid the customers, markets, and regulators in identifying which market participants are failing to complete their obligations.

- This information should be disseminated by the exchanges and the clearing agencies. Each broker-dealer could report its individualized information to the SRO which would post the individualized and aggregate data on the SRO's web site.[33] DTCC should report its information on a web site accessible by the public.

- This information should be posted and made available on a daily basis. Any Short squeezes that result can be viewed as a natural reaction by the

[31] Recent news reports have described how some brokerage firms report trading activity far in excess of what actually trades on the exchanges. These discrepancies total more than 30 million shares daily. Onaran and Ortega, *Investing: Regulator investigates inflated trade reports*, Int'l Herald Tribune, Sept. 12, 2006 (found at www.iht.com/articles/2006/09/11/bloomberg/bxinvest.php).

[32] Alternatively, the discrepancy might indicate a reporting flaw by the exchange or clearing agency. If so, it still will be important to identify the error and correct it.

[33] The web site also could identify how much of a discrepancy existed between the individual amounts reported by the broker-dealers and the aggregate amount known to the SRO. If the discrepancy is large, market participants need to factor this information into their trading decisions.

market to speculative bets by other traders. Market participants deserve to have this information and to act on it. This type of transparency will have the natural result of increasing liquidity in the markets as well as public confidence. Traders fearful of short squeezes can protect themselves by immediately covering all short sales and by ensuring reliable sources for its stock borrowing. Regulators should not aid and abet speculators in their attempts to avoid the risks associated with the speculative trading.

- *Closing out should require purchasing, not just borrowing*. When stock is borrowed, the potential for duplication (multiplicity) arises. Further borrowing, to satisfy settlement obligations, does not eliminate this multiplicity or its associated ills (overvoting, disenfranchisement, artificial increase in supply, and depressive effect on prices). Market integrity is achieved best by insisting that positions be closed out by *purchasing* securities. After the fact borrowing, to cover one short position, is akin to taking a cash advance on one credit card to make a minimum payment on the overdue balance of another credit card. In that case, like stock borrowing to cover a delivery failure, the size of the underlying debt has not been reduced. A purchase is the only means of returning to the equilibrium that must exist in a system where each share represents a single opportunity to buy, sell, or hold. The SRO or DTCC should automatically buy in shares to cover the fails and assign the cost of those shares to the parties responsible for any fails.

- *Creating a market for less liquid securities*. Will allowing market makers to sell securities they do not own, but not requiring them to deliver those securities by the settlement date, enable them to create a market for those securities? The more appropriate question is whether such a practice is healthy. We believe that the answer is clearly no, and offer two reasons in support of our position. First, this creates a distortion of market forces. By selling securities they do not own, market makers create fictional shares. This has the effect of depressing stock prices artificially. Second, this practice makes no economic sense. The only reason a market maker would need permission to fail to deliver securities is if they were selling securities they did not own. This situation is indicative of "buying" pressure, not selling pressure. We would not expect market makers to engage in this conduct because of the financial risk. If a market has buying pressure and the market maker sells shares it does not have (under the theory it is providing liquidity to the market), the market maker will not want to cover by buying shares – in a rising market. We do not believe that market makers would long survive by selling fictitious shares in a rising market and covering them at a later time. If there is buying pressure, the more appropriate response is for the market maker to raise its asking price.

- *Documenting the customer's ability to deliver*. The Commission should amend Regulation SHO to require brokers making a long sale to make a notation on the order tickets as to the location of the shares being sold and the reasons the broker believes those shares will be delivered on time. The volume of outstanding fails is too large to permit the execution of trades where there is doubt about delivery.

The immobilization of shares makes this an easy process for most customers. However, any customer that decides to keep the shares somewhere else than with the selling broker must assume the responsibility to demonstrate both the ability and intent to deliver those shares on time. Broker-dealer firms should view this as in their best interests. So long as the firms have taken steps to confirm the customers' intent to deliver shares, the firms have little or no exposure to regulatory sanction: the onus then would be placed on the customer.

- Limiting the Options Market Maker Exception. The options market maker exception recognizes the reality that some open fail positions operate as a hedge against open options positions. However, once that option expires or is liquidated, the open fail position ceases to be a hedge. It then becomes an open speculative position. Any fail positions open at the time an options position has expired or is liquidated should be closed out promptly. We urge the Commission to require the close out within five days after settlement, rather than 13. We also believe that a 35-day phase in period for limiting this exception is unnecessary in light of the extensive public attention these rule proposals have generated; options market makers already are on notice that open fail positions should not be maintained after the hedged options positions expire. Shares that cannot be closed out easily may demonstrate failures in both the equity and options markets.

  - *The exception should not be limited to threshold securities with high levels of fails*. Excusing an options market maker from having to deliver securities sold is justifiable only to the extent that the short sale constitutes a hedge against an open options position. When that short position ceases to be a hedge, it is purely a speculative position. Such a position should be subject to close-out requirements like any other speculative holding and like any other short sale. Such a speculative position does not become justified simply because an insufficient number of other short sellers have also failed to deliver these shares. Speculative positions should be required to be closed out promptly. Otherwise, additional shares have been created; broker-dealers will trade and profit from the existence of these artificial shares. If the underlying security cannot be delivered as promised or if market volatility results, the commission should examine the effects options trading have on prices in the equity markets.

  - *Broker-dealers should be required to document eligibility for the exception*. This exception, like all exceptions, should be narrowly construed and limited to use only to the extent necessary. After all, this exception permits the creation and maintenance of open fail positions. Any broker-dealer wanting to claim that its open fail positions exist in reliance on this exception should have in its files documentation: 1) identifying which options positions are hedged by which open fail positions, 2) showing that steps are in place to alert the broker-dealer that options related to open fails have expired or terminated, and 3) demonstrating that open fails were closed out promptly after the options expired or were terminated. These records will facilitate regulatory inquiries and should be demanded by clearing agencies who inquire about the reasons for the open fails. The absence

of such documentation should preclude an option trader or a broker-dealer from claiming the exception. If the open fail *is* caused by a hedge to an open options position, documentation should establish that nexus. If the documentation is not there, the broker-dealer should not be permitted to invent an excuse after the fact.

- *Excepted positions should not be moved*. Open fail positions should be tied to specific open options positions. When those options positions expire, the fail positions should be closed out. If new options positions are created and a hedge is desired, new short positions can be established. If broker-dealers were allowed to move excepted positions to new options positions, rather than close them out, it would invite schemes to avoid having to close out. In those situations, a firm might enter into options transactions for the sole purpose of avoiding a close out of a fail position. *This is not the purpose of options.* Options should be created, traded, offset, or permitted to expire for economic purposes, not as a means of avoiding a close-out requirement. Regulation SHO should not be amended to permit this type of move.

- *No phase-in period is appropriate*. Firms have been on notice since July 19, 2006 that they will have to close out open fail positions when these amendments are adopted. That adoption might not occur until early 2007. The six months (or longer) during which these rules are under consideration are more than adequate for firms to close out any open fail positions that are not tied to current options positions. At most, firms should be given five trading days after options expiration to close out any open fails.

Benefits of the Proposal. We concur with and endorse the benefits identified by the SEC staff in the Proposing Release. These amendments will increase the frequency of investors receiving the shares they purchase and the benefits associated with that share ownership. Investors will have greater confidence that the shares purchased will be delivered. All market participants will have increased assurance that all investors are being treated fairly.

Benefits also will redound to issuers and holders of securities of those issuers, particularly holders of threshold securities. Investors will be more willing to make capital commitments. Issuers will be confident that they will be the beneficiaries of any actions that increase the actual or artificial number of shares outstanding.

The markets will benefit with increased fairness, an improved reputation, and enhanced price efficiency. The capital markets should seek to aid capital formation by issuers, not seek to obscure trading activity or protect broker-dealers from risk. Risk is the province of broker-dealers. In light of record profits recently reported by some broker-dealers, it is apparent that firms do not need to protect them from risks.

ADDITIONAL ACTIONS THE SEC SHOULD TAKE

The changes proposed by the Commission and the recommendations in this comment letter will reduce the incidence of abusive short selling and should lower the number of outstanding fails.

But more is needed. The state recommends that the Commission initiate action to accomplish the following additional steps:

1. Mandatory Pre-Borrow. Pre-borrowing should be required in the following instances:

   a. *Broker-dealer settlement failures*. All short transactions by a broker-dealer involving any security should require pre-borrowing if any trades executed in the past by the broker-dealer have not been settled by delivery within five days after settlement date. If the firm has not satisfied its settlement obligations on prior short transactions of any nature, the firm should be precluded from engaging in future short transactions through the use of locates instead of actual borrowing.

   b. *Extended fails*. For any security listed as a threshold security for more than five days, any broker-dealer executing a short sale should be required to pre-borrow the securities. While this might impose a slight additional burden on broker-dealers when the threshold designation was caused by the settlement failures of other broker-dealers, market integrity and investor confidence must be the paramount concern. To the extent that the pre-borrow requirement imposes a hardship, these broker-dealers can put additional pressure on the defaulting broker-dealer to deliver its missing shares. This result would be aided by the requirement, discussed below, that clearing agencies, exchanges, and broker-dealers report their fails for each security.

2. Reduce Threshold Parameters. The criteria used to determine when a security becomes a threshold security must be tightened. The SEC and the markets have adjusted to the requirements of Regulation SHO. It is now time to narrow further the ability of traders to engage in abusive practices. The definition of Regulation SHO should be further limited by:

   a. Reducing the number of outstanding fails that trigger threshold design action from 10,000 to 5,000;

   b. Lowering the percentage test from 0.5% to 0.25%; and

   c. Reducing the number of days in which open fails can exist before the threshold designation is triggered to three days. It must be remembered that a firm that had shorted securities already has three days to arrange for delivery of those shares. In addition, the firm will have had three additional days of trading in which net long positions of the firm can offset outstanding delivery failures. Three days time to buy in or borrow to cover short positions should be sufficient. This is especially true since the firm also has three additional days of trading activity to offset any delivery shortfalls.

3. Disclosure of Fails. There should be greater disclosure to the markets and regulators of the extent of fails and the source of fails. This should include reporting by clearing firms, exchanges and broker-dealers:

a. *Clearing agencies and exchanges*. Those markets engaged in the execution and settlement of securities transactions should disclose to market participants and the public the extent of fails for each security. This should include both daily fails and cumulative fails for the security. Public disclosure of this information will enable market participants to make better-informed decisions about securities that are the subject of outstanding fails, including whether the price of the stock is artificially depressed due to multiplicity (caused by the undelivered securities). Clearing agencies also should identify which broker-dealers have fails in each security. Doing so should 1) encourage those firms to eliminate the outstanding fails, 2) permit other broker-dealers to pressure those firms to clear up the fails so the other firms will not have to pre-borrow those securities, 3) identify which firms demonstrate patterns of delivery failures (in the process, enabling regulators to focus attention on those firms to determine the causes), and 4) publicly identify which securities targeted by short sellers involve short selling without delivery of sales.[34]

b. *Broker-dealers*. Each firm should be required to report to the exchange and clearing agency the outstanding fails it has caused and what is being done to close out those positions. Copies of these reports also should be maintained by the broker-dealer. This reporting requirement should be triggered by events such as new delivery failures or be a periodic report of all outstanding delivery failures.

c. *Ex-clearing*. Broker-dealers that execute and settle trades outside the exchanges and clearing agencies (ex-clearing) should be required to report all delivery failures. This is information that belongs in the marketplace. In addition, regulations should not be more lax for conduct that occurs off-market than on-market. Without knowing what volume of fails from ex-clearing is outstanding, regulators and the market cannot be confident abuses are not occurring.

4. Close-Out Obligations. Transactions that cause a security to become a threshold security should be subject to Regulation SHO's close-out requirements. This can be accomplished by the suggestion above that firms cannot engage in any short sales if there are outstanding fails of that security (without regard to whether the stock is a threshold security or whether the fail was pre- or post- designation) unless the firm pre-borrows the shares. Alternatively, all transactions causing threshold designations could be treated as triggers for a pre-borrowing requirement for any firm wanting to short this security.

5. All Locates Must be Firm. If a broker-dealer decides to enter short trades based on a locate rather than pre-borrowing the security, that broker-dealer must be obligated to ensure that the locate is firm. Stock lenders must be required to decrement any shares that are being used by others as a locate. The same shares cannot be used for multiple

[34] In some ways, this might facilitate short squeezes. However, traders can protect themselves from short squeezes by delivering securities they have sold. In addition, the fear of being the subject of a short squeeze should be a natural market incentive to avoid delivery failures.

locates.[35] We would expect that a market could and should develop in which lenders of securities offer on an electronic market their shares available to lend. Each lender could identify which securities it offers to lend, the price, and any other terms. Those needing to borrow shares would have a central location from which to determine the availability of shares and the cost. Lenders could set a variable price depending on whether the seller simply wants a locate or wants to borrow.[36] Lenders would be required to remove from the market any shares reserved for use by a borrower. Such a system could reduce uncertainty as to the availability of shares at settlement date and the price a borrower will pay for the shares.[37]

6. Insist that Close Out Be Done with Purchased Shares, Not Borrowed Shares. Broker-dealers may use borrowed shares to effectuate short sales. The firm has three days after the transaction to deliver shares for settlement, including the ability to borrow shares during that three-day period to meet its settlement obligation. However, if shares have not been delivered by the settlement date, the broker-dealer must close out that settlement failure by delivery of shares. The commission should require that close out be done with shares 'purchased' in the market and not permit the close out to be satisfied with borrowed shares or by means of off setting transactions.

7. Treatment of Public Customers. Broker-dealers should be required to improve the disclosure to customers of the effects of stock borrowing on those customers. This should include:

   a. *Customer notification*. Customers should be notified if shares held in the customer's margin account are lent out by the broker-dealer. This could be done by sending separate notification to the customer when the lending occurs or making a notation on the customers' periodic account statements that the shares have been lent out and that the customer only has an *entitlement* to replacement shares.[38]

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[35] Customers also should be required to document affirmatively the legitimacy of locates they provide.

[36] This has similarities to the current practice of lenders publishing their own lists of stock available to lend. A central clearing house would increase transparency and reduce costs. Regardless whether the current system is maintained or a central marker is created, securities must be removed from the list when used as a locate.

[37] An electronic matching service would be expected to reduce the prices to broker-dealers and customers of borrowing stocks. The competition among lenders and the transparency resulting from public listing of costs should push borrowing cost lower.

[38] Disclosing to customers that shares in their margin accounts have been lent to others should help reduce one of the leading causes of settlement failures. Many delivery failures are a result of long fails. This occurs when a broker-dealer has lent out to others a number of shares approximating the number of shares held in customer accounts that are available to lend (*i.e.*, long positions) Then, if one of the long customers decides to sell her shares (motivated, perhaps, by the downward price trend caused by so many short sellers), the broker-dealer has no shares to deliver for that long sale. In this situation, the broker-dealer who has lent out all of its available shares must buy (or borrow) shares to replace those borrowed from the customer. A broker-dealer's failure to buy or borrow shares to cover the customer's long sale still results in a delivery failure. While the failure technically derives from a long sale, the failure's original cause was the firm loaning out all its available shares to others (in order to maximize income to the firm) and not being able to deliver shares ostensibly held in the client account.

b. *Proxy and voting materials*. Broker-dealers should be precluded from sending proxy or voting information to customers whose shares have been lent. Instead, the firm should send notification to the customer that proxy materials have been distributed by the company but are not being forwarded to the customer because the shares have been lent out.

c. *Notification of delivery failures*. Broker-dealers should be required to notify customers if securities purchased by the customer have not been delivered in a timely manner. This would require that DTCC/NSCC notify the broker-dealer that the clearing agency has not received sufficient shares from selling brokers to cover the long transactions. DTCC also should identify which broker-dealers are responsible for delivery failures.[39]

d. *Disclosure of overvoting effects*. If overvoting occurs, a broker-dealer should notify any of its customers whose votes were not counted or whose votes were discounted. Shareholders must be told if their votes are not fully counted.

8. Actions by Clearing Agencies. The clearing agencies could do much to solve the problems identified in this letter. This would instill discipline on market participants and enhance investor confidence that all possible actions are being taken to ensure accurate settlement. If there is no penalty for failing to deliver shares, firms will continue to permit this practice. Instead, regulations should create strong incentives for brokers to deliver shares on time. Actions that could be taken by clearing firms to promote market integrity include:

a. *Allocate fails to broker-dealers*. If a settlement date reveals a net short in transactions for a particular trade date, DTCC/NSCC should borrow shares from participants through its stock-borrow program then allocate those delivery obligations on the borrowed securities (and related costs) to buyers. The obligations could be allocated on a proportionate basis to all firms with buy orders or allocated according to the type of buyer – ranging from broker-dealer proprietary trades to individual customer transactions.[40] Each broker-dealer then assigned a portion of the fail would have the option to either buy in the securities necessary to deliver its portion of the borrowed shares[41] or to amend the customer order to reflect that the trade was only partially filled.[42] Regardless, the trades would be reconciled and settled within a few days of the settlement failure.

b. *Mandatory buy in*. In our view, the optimum approach would be for the Commission to require DTCC to buy in automatically to cover any delivery failures that extend beyond five days after settlement. This would eliminate

[39] This requirement would be unnecessary if the Commission were to adopt another recommendation we are making, that DTCC/NSCC automatically buy in all fails that extend a certain time after settlement date.
[40] It is our preference that fails be allocated first to broker-dealer proprietary accounts, then to institutional investors, then to individual investors.
[41] This buy in should be required to be completed within five days after settlement date.
[42] In this situation, the broker-dealer's portion of the borrowed shares could be canceled.

extended fails and prevent the free-riding and other ills associated with abusive trading.

c. *CNS records*. Trades settled through CNS should be structured and analyzed in a manner that permits identification of which delivery failures result from short sales. Moreover, CNS should identify the broker-dealers responsible for those delivery failures. Without this information, it is difficult to target abusers.

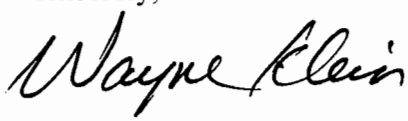
d. *Cooperation*. The Commission must take all necessary steps to ensure that DTCC and its subsidiaries are required to cooperate with all state securities regulators who are undertaking lawful investigations regarding possible violations of their anti-fraud provisions. DTCC cannot be allowed to hide behind jurisdictional claims or assert that privacy concerns preclude it from sharing information about broker-dealer transactions with state regulators.

Many of these recommendations are interrelated and interdependent. They should all be implemented as part of a comprehensive set of changes that will eliminate opportunities for abuse. For example, additional disclosures of open fail positions might cause 'piling on' by other short sellers unless there also are strict pre-borrowing and close-out requirements.

CONCLUSION

Thank you for considering our comments. We stand ready to work with the Commission, the SROs, and the securities industry to prevent the types of abuses that are being seen with short selling and delivery failures. With the assistance of all these groups, we can improve market integrity, shareholder protection, and the capital-raising process.

Sincerely,



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