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Secretary
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Dear Secretary:

Here are my comments on the Emergency Order and other issues regarding short selling and settlement failures.

The Emergency Order was a mostly cosmetic event.

On July 15, 2008, the Commission issued a temporary Emergency Order that required short sellers to actually arrange to borrow the shares before shorting the shares of 19 financial companies. This was an unusual order because it bypassed the normal notice and comment periods for SEC rulemaking. It was also unusual because these companies were not particularly hard to borrow or having serious problems with settlement failures. On July 18, 2008, the Commission appropriately amended the order to exempt market makers from the need to pre borrow.

As the stocks were generally easy to borrow, the practical impact of the order was that brokerage firm back offices had to scramble to make binding agreements to borrow the number of shares they might need

in advance, rather than just relying on the fact that these stocks were generally on the easy-to-borrow lists that were generally acceptable.

Thus, such an action would not be expected to have a major impact on the amount of short selling that actually occurred. As a personal investor, I experimented with different accounts to see the impact the ability to short. E*Trade would not permit me to short FNM or FRE for the entire first week. Interactive Brokers, would not permit an immediate short on the first day of the implementation, but within a few days reported shares available for shorting. So the real effect of the order was more work for brokerage firm back offices with little impact on the ability for professional players to short the stock.

The Emergency Order may have been a much needed slap in the face to calm a hysterical market.

These are unusual times. The United States was faced with the prospect of a financial panic affecting Fannie Mae and Freddie Mac, two firms that are at the heart of the U.S. mortgage financing system. These two companies are now handling the majority of all mortgages still being done in this country. They are basically specialized banks that raise money from the capital markets to fund home mortgages. If these two firms stopped functioning, then our little r –recession would turn into a Big D Depression very quickly. As financial firms, their ability to do business is based on their ability to raise funds from the capital markets. Any whiff of potential insolvency will make the capital markets stop funding these firms. The stock prices of these two firms were melting faster than a snow ball on a hot summer day, indicating a rapidly accelerating loss of confidence in the two firms.

The Fed stepped in and opened its discount window to Fannie and Freddie, but this did not stem the decline in their stock prices. The stocks rallied for about 15 minutes and then resumed their declines. What should the government do next?

In this context, the mostly symbolic emergency order may have made sense. It was a slap in the face designed to calm a hysterical market. It sent a strong signal that regulators would not let a short driven panic alone bring down Fannie and Freddie. (Whether the fundamental economics of their situation will bring them down is another matter altogether.) We will never know what would have happened had the SEC not stepped in at that point.

However, the action also brings up obvious questions. What was the impact on the market? Having admitted that naked short selling is a problem, what will the Commission do to protect the over 12,000 public companies that were not subject to the Emergency Order? What should it do about the problems affecting other firms that have experienced protracted settlement failures in their stocks for years?

The lack of data about short transactions makes it hard to examine the impact of the order.

There is no transparent way for the general public to find out for sure what the real impact of the order was on short selling, because the Commission no longer requires the exchanges to reveal which trades

were short and which were not. During the Regulation SHO pilot the Commission performed a well designed and carefully controlled pilot experiment that demonstrated that the old uptick rule was useless. As part of this pilot, the commission required exchanges to release data regarding which trades were short. This requirement was scrapped at the end of the pilot, despite the plea in my earlier comment letter that such data should continue to be made available.[1]

Alas, the Commission, to use a technical term, <expletive deleted> royally when it no longer required exchanges to reveal details about which trades are short and which are not. The increase in overall market volatility subsequent to the scrapping of the useless uptick rule has led many market observers to commit the *post hoc ergo propter hoc* ("after this, therefore because of this") fallacy. The scrapping of the old uptick rule did not cause the subprime havoc or the price of crude oil to double. When the subprime and energy problems became apparent to the markets, volatility naturally rose as a result.

Now many misguided voices are responding to the increase in volatility by calling for a return to the uptick rule. It would be easier to judge the impact their well meaning but misguided calls if we had better data regarding short selling and related settlement failures.

Short selling has always been a vital but controversial facet of our financial markets. It is also widely misunderstood and mistrusted. Although short selling is an important part of our capital markets, there are abuses and dangers associated with the practice. The spread of false negative information can destroy otherwise productive enterprises. There is the potential for unlimited short selling to exacerbate financial panics. Better information will assure the capital markets when there is no problem, and better information will help to alert the capital markets and the regulators when there is a problem.

<u>The Commission should improve transparency with regard to short selling.</u>

With better data regarding short transactions, short interest, and settlement failures, investors can determine for themselves the extent of problems. Accordingly, the Commission should improve transparency with respect to short selling in the following ways:

- Reinstate the required publication by the exchanges of tick-by-tick data regarding short transactions. They should, of course, be allowed to charge for this data.
- Speed up the release of the settlement failure data. Currently the SEC releases aggregate failure data on a stock by stock basis quarterly. Rather than the current quarterly release, the data should be released by NSCC on a rolling basis with only a minor delay, perhaps one week. Such a delay would prevent the use of the data to manipulate the market, yet it would allow the timely determination of whether or not there are serious settlement failures in a stock.

[1] The NYSE does release this data as part of its commercial data products, but most of the other exchanges no longer release this data.

- Consider requiring more frequent disclosure of the overnight short interest data. Currently, the data are released twice a month. The Commission should investigate the feasibility of weekly or even daily disclosure. More frequent disclosure would permit faster and more accurate determination of the extent of short selling related problems.
- Clarify the instructions to Form 13F to make it clear that the quarterly requirement to report holdings means short as well as long positions, along with derivative positions.

I do not make such calls for more transparency lightly. I am well aware that the forced involuntary disclosure of information involves the imposition of costs on the reporting entities, an overriding of their financial privacy, as well as a reduction in the legal protection of their intellectual property. Such actions should only be taken when there is an overwhelming public interest. The proper functioning of our capital markets is just such an overwhelming public interest. The lack of good and timely information at the very least breeds mistrust among investors. Such mistrust may cause investors to stay away from the U.S. capital markets, leading to less investment, fewer jobs, and less economic growth. At worst, such lack of information creates dark corners in which manipulators may operate. As Justice Louis Brandeis is often paraphrased, "Sunlight is the best disinfectant."[2]

Extending a hard pre-borrow requirement to the entire market would be extremely burdensome.

Some have called for extending pre-borrow requirements to a larger group of stocks or even the entire market. Although the pre-borrow requirement in the Emergency Order seems to be mostly cosmetic, it was not without cost. Borrowing costs rose for the stocks in question, and brokerage firm operations personnel had to manually assure compliance for the 19 stocks in question. Extending such a requirement to a broader list of stocks would impose serious re-engineering costs on brokerage firms. It could also seriously harm the liquidity of smaller stocks by reducing trading in such stocks. It is unclear that the benefits of such a move would outweigh the costs.

Some kind of brake on panic shorting might make sense in extreme situations.

The equity markets have evolved from markets in which people trade with people to markets in which computers trade with computers. Market movements now occur at the speed of light. Alas, humans still think at human speed. Most other developed capital markets have some kind of automatic stock-by-stock circuit breakers that are triggered in the event of unusual price fluctuations. The U.S. does not. Such circuit breakers may be useful in the event of extreme market reactions.

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[2] The exact quote is "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." From *Other People's Money, and How the Bankers Use It,* 1933. From http://www.brandeis.edu/investigate/sunlight/

For example, on July 18, 2008 Overstock.com, which was not then on the SEC Threshold List, made an earnings announcement, and the stock price dropped 41%. Now, the market can and should react quickly to the information in company announcements.

However, the stock soon wound up on the Regulation SHO Threshold list of stocks with significant failures to deliver. The exact amount of the failures has not yet been made public by the SEC, but the implication is clear: There was probably a significant amount of naked short selling on the day of the rapid decline. The stock then recovered approximately 10% to the $18 dollar range. Was the 41% good price discovery, or was there an overreaction fueled by naked short selling? If so, what, if anything, should be done about it?

The uptick rule was useless and should not be resurrected.

The SEC staff recommended the elimination of the uptick rule in 1975, and the Commission finally listened and eliminated it in 2007. The old uptick rule was a sham. It did little to restrict short selling, and yet it imposed high compliance costs on the industry and enforcement costs on the government. Even before the reduction in tick size from eighths to pennies, it was clear that the rule was useless.

In today's fluttering markets, any kind of tick test would be a compliance and enforcement nightmare.

In today's computer driven markets, prices can and do fluctuate extremely rapidly. There may be dozens of transactions at vastly different prices within a given second, especially around the opening or at the time of a news announcement. Which price would the last price for the purpose of a price test? One trading platform may execute a trade a nanosecond before another platform, but due to a few milliseconds of delay in reporting, it may look like it executed the trade after the other platform. It will be extremely

hard for honest and well meaning firms to ensure compliance with any kind of price test based on the last trade.

A price test based on the previous day's close would be easier to implement and enforce.

If a price test is desired – and I am not sure at this time that any price test is really needed – then it should be based on the closing price of the previous day. The closing price for the previous day is widely disseminated and remains stable throughout the day, making compliance much easier.

The Commission should consider a "Down 5% hard borrow rule."

Most other nations with electronic markets have some kind of automatic circuit breaker in the event of major jumps in the price of a stock. Given the concerns about short induced price panics, it could make sense for the commission to require hard borrowing of the stock only to execute trades at prices more than 5% below the previous day's closing price.

Such a rule would work as follows: If the stock price drops more than 5% from the previous day's close, then traders would be required to actually arrange to borrow the shares before executing any trade. Of course, legitimate market makers should be exempt, because they must act quickly in order to provide liquidity and because they cover many of their positions before the end of the day.

This rule would provide a brake in times of extreme market stress. It would prevent naked short sellers from piling on to bad news and contributing to a market panic. By preventing naked short selling during such times, it would also prevent settlement failures that seem to occur subsequent to some rapid price drops.

By only kicking in when the stop has dropped more than five percent, the rule would permit short sellers to engage in their normally beneficial activities without hindrance in normal circumstances. Short selling is a vital part of our capital markets. Short selling allows liquidity providers such as market makers to provide liquidity. Short selling makes it possible for arbitrageurs to keep the prices of ETFs and other derivatives linked to the cash equities. Short selling also facilitates the incorporation of all information – positive as well as negative – into a stock's price.

The Commission should continue to work on preventing settlement failures.

The Commission should also continue with other steps to clean up settlement failures. The basic problem with the Regulation SHO trajectory is that it does nothing to prevent failures in the first place. It just puts in complex cleanup requirements after the fact.

As I have mentioned in my previous comment letters, settlement failures are primarily an economic event: They occur when participants find it cheaper to fail to deliver than to pay the market rates to borrow the securities. Until the Commission fixes the economic incentives to fail, market participants will fail when

it is in their economic advantage to do so. Here are some of the things that the commission can do to prevent settlement failures:

- Reduce the cost of borrowing fully paid shares by updating Rule 15c3-3.
- Support improvements in the stock lending market to reduce cost of borrowing shares. In particular, it would be useful to have a central counterparty to eliminate credit issues in stock lending.
- Require clearing entities to charge late fees for failures to deliver more than three days past the settlement date.
- Eliminate option market maker exemption from Regulation SHO buy-in requirements.

Respectfully submitted,

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References

Previous comment letters by James Angel, Georgetown University, on Regulation SHO:

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