File No. S7-08-08: Comments on Proposed Naked Short Selling Anti-Fraud Rule, 10b-21

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I am Dr. Robert J. Shapiro, the chairman of Sonecon, LLC, an economic analysis and advisory firm in Washington, D.C. I am also currently a Senior Fellow of the Georgetown University School of Business, Director of the NDN Project on Globalization and a Fellow of the Progressive Policy Institute. From 1998 to 2001, I was the U.S. Under Secretary of Commerce for Economic Affairs. Prior to that, I was the Vice President and co-founder of the Progressive Policy Institute, Vice President of the Progressive Foundation, and Legislative Director and Economic Counsel for Senator Daniel Patrick Moynihan. I have advised numerous public officials, including President Bill Clinton, Prime Minister Tony Blair, Vice President Al Gore, and Senators Joseph Lieberman, Hillary Clinton, John Kerry and Evan Bayh, as well as many large U.S. and foreign corporations and financial institutions. I hold a Ph.D. and M.A. from Harvard University, as well as a M.Sc. from the London School of Economics and Political Science, and an A.B. from the University of Chicago. I also have been a fellow of Harvard University, the National Bureau of Economic Research, and the Brookings Institution, and I have conducted extensive research and analysis involving U.S. financial markets.

I currently advise the law firms of O'Quinn, Laminack and Pirtle and Christian, Smith and Jewell on economic issues related to short sales. However, the views expressed here are my own and do not represent those of any firm or person that I currently advise or whom I have advised in the past.

First, I commend the Securities and Exchange Commission ("Commission") for its decision to apply new anti-fraud rules to those who deceive others "about their intention or ability to deliver securities in time for settlement and that fail to deliver securities by settlement date," including "short sellers who deceive their broker-dealers about their sources of borrowable shares for purposes of complying with Regulation SHO's "locate" requirement." As I have noted in previous submissions to the Commission and meetings with its senior staff, and as the Commission now notes, these failures-to-deliver or "fails" affect significant numbers of stocks and in many cases "have a negative effect on shareholders" and create "a misleading impression of the market for an issuer's securities." These current SEC findings refute the positions of numerous financial institutions and public statements by officials of the Depository Trust and Clearing Corporation (DTCC), and will be welcomed by shareholders and disinterested analysts of U.S. equity markets.

I further commend the Commission for publicly noting, as a matter of importance for the integrity of U.S. equity markets, that "a seller misrepresenting its short sale locate source or ownership of shares may intend to fail to deliver securities in time for settlement and, therefore engage in abusive "naked" short selling." As I and others have documented in submissions to the Commission and academic studies, such abusive short sale behavior has seriously damaged or destroyed hundreds of U.S. companies that otherwise might have prospered, including numerous instances in which abusive naked short sales crippled young enterprises working to develop promising advances in medicine, energy, information technology, and other areas of potential public benefit. I also commend the Commission for "highlighting the illegality" of investors who carry out naked short sales that effectively deceive others "about their intention or ability to deliver securities in time for settlement," which should settle the debate over the basic illegality of naked short sales.

The dimensions of these problems are substantial. Many analysts have established that short sales now account for one quarter or more of all equity trading in the United States. For example, I analyzed data covering trading on the New York Stock Exchange from February 1, 2006 to July 31, 2006[1] and found that short sales accounted for 25.5 percent of all NYSE shares traded on a daily basis, or an average of 297 million shares per day. Our analysis further found that the lower a company's share price, the greater the proportion of short sales in the trading of its shares: Among NYSE companies selling for $20 or less per share, short sales accounted for about 28 percent of all shares traded. The complete analysis and database are available for the Commission's review on request.

Further, the Commission notes that on an average day, new fails in threshold securities, which mainly reflect naked short sales, represent 0.6 percent of the dollar value of trading in all securities. In March 2008, the estimated dollar value of daily trading on the NYSE and NASDAQ alone was more than $240 billion. There are no reliable measurements of trading through other means and venues, but they may also be substantial. Restricting our estimates to NYSE and NASDAQ trading, the Commission's estimate of the relative dimensions of new fails suggests that every day, some $1.44 billion in securities fail to deliver; and the aggregate value of fails on an average day is many times greater.

The prospect that these fails represent abusive naked short sales, they can distort the market for particular securities; and if the fails are concentrated in a small number of companies' shares, the distorting impact can be very substantial. The relatively small share of securities that are designated as threshold securities—on one recent day, for example, an average of 143 of the 3,216 issues on the NASDAQ and 95 of 2,815 listings on the NYSE and ARCA, or about 4 percent of all listed issues -- establishes that fails are concentrated. Moreover, additional data suggest that these fails are further concentrated among a relatively small subset of all threshold securities. In an earlier comment to this Commission, we provided data and analysis regarding the trading volume and outstanding short interest of NYSE and NASDAQ-NM stocks listed as threshold securities on three random days in 2005. We hypothesize that for a given number of outstanding fails across all threshold securities, the largest numbers of those fails are likely to have occurred in the securities that account for the largest shares of the total trading volume in those threshold securities and the largest shares of their total outstanding short interest. The data show that trading volume and short interest in threshold securities are highly concentrated in a small subset: 10.5 percent of threshold securities accounted for 73.8 percent of the trading volume and 74.7 percent of the short interest in all threshold securities. These data suggest that

[1] The data covered trades transacted through the Super Designated Order Turnaround System (SDOT) for six months The SDOT system captures more than 85 percent of all orders executed on the NYSE, from, a sample of 1,947 NYSE-listed operating companies that excluded closed-end funds and exchange traded funds.

extended fails in all likelihood are highly concentrated on any given day in some 10 to 20 stocks, at levels far above the threshold level of harm to the market for those stocks, and levels that suggests massive, naked short sales that could seriously damage the affected companies.[2]

Given the substantial dimensions and serious implications of fails to deliver, especially when they represent abusive naked short sales, I urge the Commission to implement its proposed regulation. I also recommend certain are clarification about its extent and additional regulation to extend its reach. The proposed regulation would declare an instance of fraud when a customer selling short shares in a threshold security misrepresents to a broker-dealer his ability or intention to borrow and deliver securities to be delivered for settlement when due, including instances in which a broker dealer sells short shares in a threshold security for its own account. There are serious reasons to extending this rule to cover all equity sales.

In eliminating the grandfather clause for settling extended fails of threshold securities, the Commission noted that naked short sales can inflict significant damage on both individual stocks and the integrity of the market through naked short sales occurring before a security is designated for the threshold list. Under the terms of Regulation SHO, an abusive naked short seller can carry out large numbers of naked short sales for as long as eight consecutive days prior to its designation as a threshold security: The short sales triggering the original failures to deliver occur on day one and become apparent on day four (T+3) and then can persist for four more trading days before a stock is designated as a threshold security. During that time, millions of fails can occur in a particular stock, sufficient to artificially drive down the share price either alone or by attracting additional, legitimate short sales, distorting the market and harming the targeted company and its current shareholders. At that point, the abusive short seller could begin to cover his naked short sales at a depressed price created by his illegal activities, reaping windfall profits. Yet, because these activities occur before the stock's formal designation as a threshold security, they may not qualify as fraud under the proposed rule. Similarly, an abusive naked short seller can carry out massive naked short sales over a period too compressed to come under Regulation SHO, and nevertheless damage the company and its shareholders, and extract profits from his manipulation. In this instance as well, these activities might not qualify as fraud under the proposed rule.

I believe it would be an error for the Commission to limit the impact of the proposed regulation to only threshold securities. In principle and practice, there are no compelling or persuasive reasons why the stipulation that fraud should attach to a short seller's misrepresentation with regard to his willingness and intention to borrow and deliver shares to cover his short sales should extend only when the misrepresentation involves stocks that have been designated as threshold securities. The activity of abusive naked short sellers in this regard should be considered a matter of fraud regardless of whether the stock in question is a threshold security and whether total failures in a stock by all naked short sellers already exceed 0.5 percent of the issue's outstanding shares. The fraud lies in the short seller's behavior and its potential costs to other shareholders, the companies they own and the integrity of the settlement system,

[2] These concerns do not alter the importance of the legitimate use of short sales in promoting the efficiency and stability of financial markets. Properly executed short sales alert investors to other investors' judgments that a firm may be over-valued and, as part of normal market making activity, can provide liquidity and offset temporary imbalances in the supply and demand for particular stocks.

especially given that such behavior can produce substantial damage in the period before the Regulation SHO threshold is passed.

Further, the Commission should clarify that its stipulation of fraud for misrepresenting a short seller's willingness and intention to borrow and deliver shares to cover a short sale position also attaches to the broker-dealer when the broker-dealer is complicit in the abusive behavior. The Commission notes that proposed rule 10b-21 would make it unlawful ,

> . . . for any person to submit an order to sell a security if such person deceives a broker-dealer, participant of a registered clearing agency, or purchaser regarding its intention or ability to deliver the security on the date delivery is due, and such person fails to deliver the security or on before the date delivery is due. Scienter would be a necessary element for a violation of the proposed rule.[3]

The Commission further notes, citing *Ernst & Ernst v Hochfelder, et. al*., 425 U.S. 185 (1976), that,

> . . . scienter may be established by a showing of either knowing conduct or by an extreme departure from the standards of ordinary care * * * which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

There are instances in which naked short sellers deliberating mislead a broker-dealer about their intention and ability to borrow the securities for delivery in the time permitted, which the proposed regulation clearly and properly covers. There also are instances in which the broker-dealer cooperates or even colludes with a customer to leave a short sale position naked, or assures the customer that the borrowing and delivery will be taken care of, confident that the DTCC stock-borrow arrangements will preserve the position. In such cases, the broker-dealer has participated in a behavior that "deceives a . . . purchaser regarding its intention or ability to deliver the security on the date delivery is due" in a way which "presents a danger of misleading buyers . . . that is either known to the defendant or is so obvious that the actor must have been aware of it." These circumstances would be most clear in cases of naked short sales which persist for several days beyond T+3, in which cases the broker dealer "must have been aware" that the shares have not been borrowed and delivered.

Following directly from the principles cited by the Commission for the proposed regulation and the holding of *Ernst & Ernst v Hochfelder, et. al.* cited by the Commission, the liability for fraud in cases of naked short sales should extend to broker-dealers who fail to exercise "standards of ordinary care" to ensure that the securities are borrowed and delivered. This clarification also follows from the Commission's stipulation in the proposed regulation that "a seller would not be making a misrepresentation . . . if the seller submits an order to sell securities that are held in a margin account but the broker-dealer has loaned out the shares pursuant to the margin requirement." In such a case, the misrepresentation clearly falls to the

[3] III. A. Proposed Anti-Fraud Rule.

broker-dealer, and ". . . as with any rule, broker-dealers could be liable for aiding and abetting a customer's fraud under the proposed rule."

This clarification also would make the proposed regulation largely self-executing and therefore achieve the Commission's goals more effectively and efficiently, since a naked short seller's broker-dealer is in the best position to know of the customer's deception and secure his speedy compliance. Further, this stipulation will actively discourage broker-dealers from cooperating in any way with short sellers intent on failing to borrow and deliver or from assuming responsibility for borrowing and delivery the securities and then failing to exercise "standards of ordinary care" to do so.

In summary, we have presented compelling reasons why the proposed rule should "apply to sales of all equity securities," and not "narrow the scope of the proposed rule to apply only to sales of "threshold securities." Such a restriction would ignore the damage which abusive naked short sales can inflict in short periods of time. Further, we have presented compelling reasons why the rule should apply to broker-dealers for behavior that facilitates naked short sales. In addition, the rule should not exclude exchange traded funds or other basket securities, since that exclusion will simply shift the focus of abusive naked short sale activities in way that could damage investor confidence in such funds.

The Commission asks for specific comment on whether there are entities other than "broker-dealers, participants of a registered clearing agency, or purchasers" that "could be deceived about a seller's intention or ability to deliver securities in time for settlement that should be included in the proposed rule." In practice, abusive naked short sales can distort the perception of the true market value of a company and so deceive all current shareholders in the company, potential investors in the company's securities, potential lenders to the issuer, and other companies or institutions conducting a range of business with the company. This deception can affect the business decisions of all those additional economic actors. Therefore, the Commission is correct in proposing that the rule be drawn broadly to hold a person "liable if it deceives 'another person' about its intention or ability to deliver securities in time for settlement."

The Commission also asks for specific comment on the extent to which the proposed rule would "impact liquidity and market quality in securities traded." With regard to the issue of naked short sales, the liquidity of the market and the market quality of securities traded can be threatened or damaged if investors perceive that naked short sales may artificially distort the price of securities, in ways and instances unknown to honest investors, and that the Commission has not taken sufficient steps to curb the abuses can produce those distortions. In this regard, the strict application of the proposed rule, especially with the clarifications noted earlier, should enhance liquidity and the market quality of securities traded.

The Commission asks for specific comment on the extent to which the proposed rule would result in short squeezes, and the impact of potential short squeezes on the efficiency of the market. Such short squeezes can occur when naked short sellers are forced to borrow large numbers of shares which they have sold but not delivered. By increasing the liability of naked short sellers, the proposed rule should reduce the incidence of naked short sales and thereby reduce the likelihood of short squeezes. The prospect of short squeezes is increased by the moral hazard that occurs when short sellers believe there is little or no cost to carrying out abusive naked short sales, and therefore rules that impose such costs reduce this prospect. Moreover, as an economic matter, when short squeezes occur as a result of rules that correct market-distorting behavior, they ultimately enhance the efficiency of the market by correcting the distortions.

The Commission further asks for specific comment on other possible costs of the proposed rule, noting,

> . . . Because the failure to deliver securities by the date delivery is due is an element for a violation of the proposed rule, as a service to customers, broker-dealers could feel an additional obligation to borrow or purchase securities to deliver on customer sales even though the broker-dealer did not enter into an arrangement with the customer to do so. The proposed rule could result in increased costs to customers who inadvertently fail to deliver securities, because such customers, in an attempt to avoid liability under the proposed rule, might purchase or borrow securities to deliver on a sale at a time when, but for the proposed rule, the seller would have allowed the fail to deliver position to remain open.

The first cost raised here would be a cost to customers, not broker-dealers; but it would not represent an additional cost, since a legitimate short sale involves borrowing the security for delivery at the cost of such borrowing. Therefore, it would reflect only the cost of complying with the rules and laws that apply to all investors. The second possibility raised here similarly involves the inherent costs of complying with the rules and laws that apply to all investors, and in the end merely recognizes that failing to comply with the rules and law avoids the costs of compliance. Strict liability for failing to deliver securities in short sales is needed to offset the implicit savings of violating the law and rules, and getting away with it.

Finally, the Commission asks for specific comment on "any additional costs or benefits beyond those discussed here" from the proposed Rule 10b-21. Strict liability for abusive naked short sales should further reduce their incidence, and thereby enhance investor confidence and the overall liquidity of U.S. equity markets. In addition, data show that the most abusive and damaging instances of naked short sales generally involve relatively young and small companies, whose shares can be most affected by large scale naked shorts. The vulnerability of such companies to these abuses can discourage companies from going public. Therefore, strict liability for such abuses may produce the additional benefit of reducing the artificial risks of going public, increasing the availability of capital for young companies and their consequent growth and development, and expanding opportunities for investors. Moreover, it is well worth noting that sound measures which promote and support investor confidence in U.S. equity markets, as would the proposed rule with the recommended clarifications, are especially important when financial institutions are highly sensitive to systemic risks, as they are today.