August 31, 2004

The Honorable William H. Donaldson
Chairman
Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549

Dear Chairman Donaldson:

I am Robert J. Shapiro, chairman of Sonecon, LLC, an economic advisory firm in Washington, D.C., and a long-time observer and analyst of U.S. and global financial markets. I served as Under Secretary of Commerce for Economic Affairs from 1998 to 2001, Vice President and co-founder of the Progressive Policy Institute from 1989 to 1998, and principal economic advisor to Governor William J. Clinton in the 1992 presidential campaign. I hold a Ph.D. from Harvard University and have been a Fellow of the National Bureau of Economic Research, the Brookings Institution, and Harvard University. I want to convey my serious concerns about the impact of the final version of Regulation SHO regarding short sales, as issued by the Securities and Exchange Commission (SEC) on July 30, 2004[1], on the fairness and transparency of our equity markets.

The SEC is certainly correct in its effort to broaden the terms of regulation of short sales. Regulation SHO takes an important step that could lead to more effective monitoring of short sales by extending the regulation to all equity transactions and directing broker dealers to mark all equity orders as "long," "short" or "short exempt." More important, the new "locate and delivery" requirements could substantially reduce stock manipulation carried out through naked short sales -- but only if those requirements are widely applied and strictly enforced. Unfortunately, Regulation SHO does not meet either of these two standards. The troubling result is that the Regulation, in effect, establishes an official level of tolerance for unsettled or naked short sales.

As Regulation SHO now stands, strict requirements to locate and deliver borrowed shares in short sale transactions are directed only to a very small subset of securities, called "threshold" securities, that 1) already have fails to deliver at a registered clearing agency of at least 10,000 shares for five consecutive settlement days, 2) when those failures equal at least one-half of one percent of the outstanding shares, and 3) the security is already included on a daily list of securities meeting these requirements published by an SRO. Only when all three of these conditions are met is a broker dealer carrying out a short sale required by Regulation SHO to borrow the security or enter into a *bona fide*

[1] 17 CFR parts 240, 241 and 241, Release No. 34-50103, File No. 87-23-03; RIN 3235-AJ00.

arrangement to do so. These provisions set a new and troubling standard for short sales: A broker can now sell short a security without borrowing the shares or arranging to do so, so long as the security does not meet one or more of those three conditions. The Depository Trust and Clearing Corporation (DTC) estimates that just 4 percent of public equities have settlement failures exceeding 0.5 percent of their outstanding shares. The SEC definition of "threshold" securities, therefore, *excludes* 96 percent of all traded securities from strict locate requirements for short sales, or nearly 9,000 of the estimated 9,350 companies currently traded on U.S. exchanges and markets.

Instead, Regulation SHO allows a broker dealer to satisfy the "locate" requirement for short sales in the securities of 96 percent of publicly-traded firms without either borrowing shares or entering into an agreement to do so, if (s)he has "reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due."[2] The Regulation further states that this "reasonable grounds" standard will be satisfied if the equity being sold short is included in a current "Easy to Borrow" list. Yet, Regulation SHO sets no standards for these "Easy to Borrow" lists, other than that repeated failures to deliver securities included on a list will indicate that reliance on that particular list does not satisfy the "reasonable grounds" test. *This provision allows a broker dealer to carry out a series of short sales without any direct evidence that the particular security being sold short is even available for borrowing.* At a minimum, the SEC should establish clear and strict standards for inclusion on "Easy to Borrow" lists based not on a list's past record of including other securities that were not ultimately delivered, but on *current evidence of the actual availability for borrowing of the number of shares of the particular security to be sold short.*

Similarly, the final Regulation imposes strict delivery requirements once an extended failure to deliver has occurred only on short sales in "threshold" securities: When the short seller of a "threshold" security has failed to deliver the securities for 10 days after the normal settlement date, or 13 consecutive settlement days, Regulation SHO requires the clearing agency to step in and itself purchase the securities for delivery. But the Regulation provides virtually no means of enforcing the delivery of non-threshold shares sold short – again, covering the securities of an estimated 96 percent of all publicly-traded companies, or nearly 9,000 from a total of 9,350 companies. Stated another way, Regulation SHO imposes no enforcement requirements on those who sell short and fail to deliver the shares, so long as the uncovered short sales of the targeted company equal less than 0.5 percent of its outstanding shares.

Nor will this "threshold" test of 0.5 percent of a company's outstanding shares protect honest investors from those who seek to manipulate a company's share price through large-scale naked short sales. Among the young public companies that are often the target of naked short sellers, most outstanding shares are held by company executives and original investors and restricted from trading trade freely. In all such cases, short sales equivalent to less than 0.5 percent of the company's outstanding shares can amount to as

[2] See Part V(A).

much as 20 to 30 percent of the shares actually available for trading, allowing stock manipulators to drive down the share price with naked shorts that still do not breach the 0.5 percent ceiling set by Regulation SHO. If the 0.5 percent standard for threshold securities is retained, the Commission at a bare minimum should apply it to registered shares available for free trading, not to outstanding shares.

These and other provisions of the final Regulation SHO are far weaker than even the draft version. The final Regulation has dropped a provision from the earlier draft that would have directed clearing agencies to report to the National Association of Security Dealers (NASD) and the designated examining authority any investor failing to deliver. More important, the final Regulation eliminated a promising proposal in the draft version that would have withheld the benefits of mark-to-market payments (e.g., return of collateral as the share price declines) from investors who fail to deliver the shares they have sold short. Without this means of enforcing the delivery of shares sold short, those who fraudulently carry out naked short sales to manipulate the price of a company's shares can continue to collect their profits to the detriment of millions of honest investors. Regulating short sales in a way that still provides those who don't deliver the shares they sell short with the profits from their uncompleted short sales violates the basic principles of a fair and free market. Moreover, no outside authority will be alerted, so long as they target their fraud to any of the nearly estimated 9,000 companies whose equities are classified as "non-threshold" securities and limit the fraud in any single case to 0.5 percent of the company's outstanding shares.

I strongly concur with the comments of the North American Securities Administrators Association (NASAA) on the draft rule: "[We are] unable to determine why the Commission proposes to permit significant settlement failures at all. While there are instances when settlement may be legitimately delayed, existing regulations provide for extensions for settlement. If the Commission continues to allow settlement failures, it may well facilitate the harm that the proposal is designed to remedy."

By exempting from strict locate and delivery requirements any failures to deliver in equity issues with existing failures of less than 0.5 percent of their outstanding shares, Regulation SHO appears to establish an official level of acceptance and tolerance for unsettled or naked short sales. I respectfully submit that that these provisions could end up providing tacit SEC approval for billions of dollars in unsettled short sales. With the value of the publicly-traded shares on all exchanges and markets totaling an estimated $20.415 trillion[3], do these provisions effectively permit unsettled short sales of 0.5 percent of that total or an estimated $102 billion a day? I respectfully request that the SEC provide an estimate of the maximum unsettled short sales that could occur under Regulation SHO without triggering locate and delivery requirements.

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[3] This total is based on the following estimates of market capitalization: NYSE: $17.4 trillion (www.nysedata.com/factbook), NASDAQ: $2.87 trillion (www.nasdaqtrader.com), Amex: $95 billion (www.amex.com), OTC-BB: $50 billion (www.otcbb.com). See also www.world-exchanges.org and Bushee, Brian and Leuz, "Economic Consequence of SEC Disclosure-Regulation: Evidence from the ORCBB," Working Paper, February 2004.

By permitting the widespread settlement failures that rightfully concern the NASAA and all honest investors, Regulation SHO effectively tolerates abuses, principally through naked short sales, that can undermine basic confidence in U.S. equity markets. Under the terms of this Regulation, naked short sellers will be able, in effect, to inject into the markets millions of shares that do not exist without triggering strict locate or delivery requirements. Whatever the legal definition, naked short sales are an economic equivalent of counterfeiting. Until Regulation SHO, this economic counterfeiting has been facilitated by electronic record keeping and the apparent practice of the DTCC and its subsidiary National Securities Clearing Corporation (NSCC) of often disregarding persistent unsettled short positions. With Regulation SHO, the SEC has provided its implicit imprimatur for the same practice in cases covering the vast majority of public companies and billions of dollars.

I urge the SEC to reconsider the provisions of Regulations SHO and, at a minimum, apply the "locate and delivery" requirements for threshold securities to all short sale transactions, and adopt a zero-tolerance policy for significant settlement failures. American investors should feel confident that the SEC will ensure the integrity of every equity transaction they undertake and fully protect their right to receive what they have paid for.

Sincerely,

Robert J. Shapiro

cc: Cynthia A. Glassman, Commissioner, Securities and Exchange Commission
Harvey J. Goldschmid, Commissioner, Securities and Exchange Commission
Paul S. Atkins, Commissioner, Securities and Exchange Commission
Roel C. Campos, Commissioner, Securities and Exchange Commission
Jill M. Consodine, Chairman and Chief Executive Officer, Depository Trust and Clearing Corporation
Donald F. Donahue, Chief Operating Officer, Depository Trust and Clearing Corporation, and President, Depository Trust Company and National Securities Clearing Corporation
Robert R. Glauber, Chairman and Chief Executive Officer, National Association of Security Dealers

Chairman
Sonecon, LLC
601 13th Street, NW
Suite 1100-North

Washington, D.C. 20005