Statement of Robert J. Shapiro

The Economic Costs of Tolerating Equity "Failures to Deliver"

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I am Robert J. Shapiro. I am chairman of Sonecon, an economic advisory firm in Washington, D.C., and former U.S. Under Secretary of Commerce for Economic Affairs under President Clinton. I am also a Senior Policy Fellow at the Georgetown University Center for Business and Public Policy and a Senior Fellow of the Progressive Policy Institute. I have served previously as a fellow of Harvard University, the National Bureau of Economic Research, and the Brookings Institution.

For the past several years, I have studied and analyzed the growing incidence and significance of "failures to deliver" or "fails," in which millions of shares are sold and paid for, but not delivered for weeks, months or even years. The majority of these fails involve short sales, in which investors pledge to borrow shares which are then sold, payment is paid, but the shares are not borrowed and delivered. I am pleased to be here today to discuss the proposal to require broker dealers to file regular reports on all ledgers and other records reflecting securities that have been sold and failed to deliver or receive.

Failures to deliver have become a significant and destructive phenomenon in our equity markets. In 2003 and early 2004, a visiting economist at the SEC, Dr. Leslie Boni, was given access to the records on fails to deliver held by the security industry organization that clears and settles almost all equity and bond trades, the Depository Trust and Clearing Corporation, or DTCC,. Dr. Boni found that on any given day, there were about 500 million shares that had been sold and gone undelivered for longer than the three day allotted to settle a trade after a sale. She found that thousands of companies were affected, and very large numbers of these fails persisted for weeks or months, indicating that the failures did not involve bookkeeping or administrative problems, but rather were deliberate. The major findings include:

- 80.3 percent of all NYSE, AMEX and NASDAQ listed stocks, and 58.2 percent of unlisted "Pink Sheet" or "Bulletin Board" stocks had fails on at least one of the three days randomly examined in the study.

- Among listed stocks with fails, the failures averaged 0.2 percent of their total outstanding shares, and the average duration of the fails was 13 business-days or two weeks and three days. For unlisted stocks with fails, the failures averaged 1.6 percent of their total outstanding shares, with an average duration of 57 business-days or almost three months.

- On any given day, over 1,000 listed stocks have failures-to-deliver that had persisted for at least one month (20 business days), and more than 700 listed firms have fails at least two-months old (40 business days). For unlisted stocks, over 900 have fails at least one-month old and over 800 have fails at least two-months old.

- On any day, there are 60 million-to-120 million shares of listed companies that have gone undelivered for at least two months (40 business days); the number of shares of unlisted companies that remain undelivered for at least two months averaged 120 million-to-180 million/day.

The large-scale, persistent failures to deliver documented by the data have become part of way that Wall Street and the Depository Trust and Clearing Corporation, which is owned by the major broker dealers and banks, conduct business. Moreover, most of these failures are what are called "naked short sales." Short sales involve an investor borrowing shares, which he then sells in the expectation that the share price will decline, at which point he buys new shares in the market, replaces those he borrowed, and profits from the difference between that lower price and the price he received for selling the borrowed shares. In a naked short sale, the short seller sells shares he does not own, but fails to borrow and deliver them to the buyer.

One might reasonably assume that a naked short sale would simply fail to be completed; but that's not what happens. The DTCC clears the sale and the proceeds are deposited with the seller's broker-dealer; and then the DTCC, which is the depository of all shares as well as the clearing organization, borrows the shares from its store of shares. In most cases, it does not require the original short seller and his broker-dealer to replace those shares. The DTCC also credits the share sit borrowed back to the original account, so if the naked short seller repeats his operation, the DTCC can use the same shares to cover the transaction, over and over again. That is an important fact, because it allows stock manipulators to carry out naked short sales involving millions of shares to drive down the price of a company that has relatively few outstanding shares that could be borrowed legitimately.

That largely what we see in the data reported by Dr. Boni and by our own independent analysis, which shows hundreds of millions of fails that persist for weeks and months at a time. These persistent naked shorts of the dimensions found in these data distort the equity markets and impose losses for investors. When short-sellers can effectively dispense with borrowing and delivering the shares they then sell short, it removes the basic economic constraint on short sales, allowing manipulative short sellers to drive down a stock's price for their own illegal profit. There are costs even when such deliberate manipulation is not involved: Broker-dealers electronically record the undelivered purchases in the buyers' accounts; and these fails produce "phantom" shares for weeks or months at a time. This process increases the effective supply of shares and so tends to depress the value of each share. To the extent that naked shorts do *not* produce phantom shares in the buyers' accounts, those buyers are not receiving what they paid for. In either case, the integrity of equity trading in the United States is impaired with the tacit assent of the institutions charged with ensuring that integrity.

Large-scale, extended fails were central element in a series of stock manipulation schemes in the late 1990s and early years of this century, often called "death spiral financing," in which criminal syndicates would invest in a company, receive shares and an agreement to receive additional shares in the future if the stock's price fell. They then flooded the market with naked

short sales and drove down the price of the stock, so they could claim millions of additional shares. They made huge profits on the naked short sales and used the additional shares to cover them. I examined 357 instances of this financing. I found that in 355 cases, these naked short sales drove down the stock's price by an average of more than 65 percent over the following year, producing billions in unnecessary losses for honest, ordinary investors in these stocks.

The use of naked shorts continues today even without a death-spiral financing instrument. In 2004, in response to years of studies and complaints that naked short sellers were being used to manipulate stock prices, the SEC adopted its first new regulation of short sales since the 1930s, called Regulation SHO. The Regulation was intended to force all short sellers to deliver the shares they sold within about 3 weeks, at least in cases in which the fails against a company equaled a threshold of at least 0.5 percent of its outstanding shares. Those companies were designated "threshold securities." Unfortunately, Regulation SHO had many loopholes. A study I conducted of first 15 months of the regulation found that after a brief decline in outstanding fails, they went back up and continued to average about 500 million shares on any given day, and sometimes much higher. Over that 15 month period, about 500 NYSE firms were listed as having at least 0.5 percent of their outstanding shares sold and undelivered, as well as more than 500 NASDAQ firms. In many cases, these companies remained on the list for many months or even years at a time, demonstrating that the regulation did not clear up large-scale, persistent fails.

Moreover, another study which we conducted found evidence that the 500 million to 600 million fails outstanding on any given day are probably concentrated in perhaps 15 to 20 firms. Such concentration strongly suggests manipulation. Yet we cannot be certain, because the DTCC has always refused to release any regular information on the numbers of fails for each company of its list of threshold securities with at least 0.5 percent of outstanding shares failed.

Earlier this year, the SEC acknowledged that its original regulation has not been able to stem naked short sales and other fails to deliver. It also rejected the DTCC's long-standing claim that fails are a minor phenomenon of little significance, and concluded that stricter regulation was required to stem the distortions and manipulations carried out through large-scale fails to deliver. As we speak, broker dealers are fighting hard to weaken the new prospective regulation..

We have to solve this problem to protect the tens of millions of honest, ordinary investors. The best way to advance this process is to expose it to the full light of day. Investors as well as regulators should be able to learn what stocks have millions of fails against them, so investors can evaluate their positions and regulators can take action. I applaud your proposal to make such information publicly available. I would only urge you to apply this requirement on at least a bi-weekly or monthly rather than a quarterly basis. With that revision, I urge you to enact the proposal in the interests of shareholders in Missouri.