Securities Lending and Short Sale Roundtable
Panel Examining Pre-Borrow and Hard Locate Requirements
Opening Statement of Dr. Frank Hatheway, NASDAQ OMX Group, Inc.

As Chief Economist for The NASDAQ OMX Group, Inc., the world's largest securities markets operator, I would like to thank you, Chairman Schapiro and Commissioners, for organizing this Roundtable on Securities Lending and Short Sales to address concerns of public investors that look to the markets and the Commission to maintain safety, transparency, and fairness for their invested savings. Issuers that list their shares on our markets and members that risk capital there also demand rules that are soundly reasoned, clearly articulated, and rigorously administered to create a safe, fair, transparent, and efficient venue for securities trading.

My remarks today are similar in theme and content to those I made at the Roundtable to Examine Short Sale Price Test and Circuit Breaker Restrictions on May 5th. First, based on numerous studies of empirical data, the Commission has been quite successful over time in reducing "fails to deliver," the primary measure of abusive, naked short selling about which NASDAQ, the Commission, and legislators are concerned. Second, the Commission achieved this success through incremental, narrowly-tailored regulatory changes that addressed specific, well-documented regulatory gaps that enabled abusive, naked short selling. Third, the Commission should continue to focus on reducing fails to deliver and abusive short selling and continue using its proven approach: careful analysis of empirical data followed by incremental regulatory responses.

The requirements of Rule 204T and subsequent Rule 204 focused on issues associated with the delivery of borrowed shares. As we turn today to the practices involved in making commitments to lend shares and consider strengthening the locate requirements, it is important to know whether there is evidence of continued abuse in the stock loan market which have not been addressed by Rule 204 or if we are here to address concerns which are more hypothetical in nature. If the latter, one course for the Commission is to monitor potential loopholes in existing regulation for signs of abusive conduct much as they did with fails to deliver. Acting on the hypothetical possibility of abusive conduct and at the same time restricting beneficial liquidity oriented behavior is not in the best interest of investors, listed companies, and market participants unless monitoring proves impossible. Baring reliable empirical evidence that steps taken to date have not been sufficient to prevent abuses in stock lending, we would encourage the Commission to continue to closely monitor this area rather than taking regulatory action at this time.

Should the Commission believe, however, that there currently exists abusive conduct in the stock loan markets, we would support the Commission taking immediate and effective steps to close any existing regulatory gaps. The question then becomes: if the Commission were convinced that empirical data supported adopting another incremental regulatory measure to combat abusive, naked short selling, what measure ought the Commission to adopt? NASDAQ OMX Chief Executive Officer Robert Greifeld has publicly urged the Commission to consider adopting a "hard locate" rule.

Under current rules, firms that maintain securities inventory for trading or lending are permitted to issue multiple locates per share, theoretically issuing multiple thousands or even multiple tens of thousand of shares in locates for every 1,000 shares in inventory. This is not to say that firms today actually issue a limitless number of locates per share. Securities lenders are constrained in issuing locates by the risk of a "short squeeze" or other event that would force simultaneous delivery of all "located" shares. Borrowers are similarly constrained from accepting locates from unreliable lenders who over commit their shares. Lenders and borrowers are encouraged to act prudently because the cost of such an event could outweigh the premiums lenders charge for issuing locates. The regulations do, however, permit firms to assess that risk on a stock-by-stock basis.

The hard locate would augment current rules by placing a fixed regulatory limit on the number of locates per share firms could issue. The limit could be fashioned in various ways. For instance, a hard locate rule could limit locates to a fixed ratio of locates to shares of 1:1, 2:1 or another number that the Commission determines the empirical data warrants. Alternatively, a hard locate could limit the dollar volume of locates issued, measured against a firm's net capital or other relevant indicator. Another option would be to adopt a sliding scale based upon the characteristics of sets of securities, firm capital, market conditions, or an analysis of all three. The essential feature of the hard locate rule is substituting a regulatory limit to replace risk-based limits.

A well-constructed hard locate rule would be a powerful, yet flexible tool for the Commission to reduce the costs of abusive short selling made possible by excessive lending, while still preserving the benefits of price discovery and liquidity made possible by prudent lending. For example, if the Commission determined to adopt a hard locate rule with a cap on the number of locates to shares held, it could implement the rule with one cap, gather data on the cap's impact on fails to deliver and on liquidity, and then adjust the cap up or down based on its careful analysis of the empirical data. This flexible, incremental approach is consistent with the Commission's past practices and it would allow the markets and market participants to adjust to the rule smoothly over time.

The Commission should also consider differential treatment for market makers. Implementing a hard locate rule or other restriction on stock lending will increase the cost of providing liquidity. A locate exemption of some scope for market makers will likely be needed to encourage market makers to continue providing liquidity Again, the empirical evidence should dictate whether the requirement for market makers is a complete exemption or is designed to offset the market maker's end-of-day short position, the maximum intra-day short position, or another measure of short interest. The impact of the hard locate rule on market maker behavior also depends on whether any price test the Commission chooses to adopt will include an exemption for market makers.

NASDAQ stands ready to assist the Commission in analyzing appropriate and necessary steps to reduce fails to deliver and abusive, naked short selling. As I stated earlier, the Commission should first determine whether sufficient empirical data exists to warrant further tightening of lending through a restriction on locates. If the Commission can make that determination, NASDAQ believes that a hard locate rule as described above would be the most effective, flexible tool to balance the overall risks, costs, and benefits associated with short selling.

Thank you very much.