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Testimony of Peter J. Driscoll,
Chairman of the Board
The Security Traders Association

Before the Securities and Exchange Commission

Short Sale and Securities Lending Roundtable
September 30, 2009

Opening Remarks

Good Morning, my name is Peter Driscoll and I am the current Chairman of The Security Traders Association (STA or The Association). The STA appreciates the opportunity to share our opinions on short sale regulation in general and abusive and naked short selling in particular.

We believe that the Securities and Exchange Commission (SEC or the Commission) should be applauded for the development and implementation of Regulation SHO. The Commission went to great lengths, via the regular notice and comment rule making process and an extended pilot implementation, to ensure that all points of view and relevant facts were examined and the new rule was appropriate for the new market structure. They really did get it right. We continue to believe that with some minor adjustments Regulation SHO can effectively control abusive short selling, including naked short selling.

The STA believes that short selling is a legitimate and economically important activity that fosters price discovery and is a critical component of overall liquidity. We commend the Commission for focusing on balancing the costs and benefits of any additional short selling restrictions at both the April 8, 2009 Open Meeting and the May 5, 2009 Roundtable. We are not aware of any evidence introduced at these meetings or in all the subsequent comment letters that showed restricting short selling would have eliminated naked or abusive short selling, increased investor confidence in any meaningful fashion or that the benefits of these regulations would outweigh the additional costs they would impose.

As a matter of fact we are not aware of any empirical studies or other credible evidence that abusive or naked short selling was behind the recent market declines. Studies conducted by Bloomberg and Deutsche Bank last year indicate that less than 10% of the trades executed were sold on consecutive down ticks during the examined period. These studies reinforce our belief that much of the decline in stock prices was the result of participants deleveraging and preparing for anticipated withdrawals and redemptions. We do not believe that expensive regulations to control abusive or naked short selling should be promulgated until there is evidence that abusive or naked short selling was responsible for the declines, that additional regulation is warranted and that that additional regulation would effectively address the identified problem.

The STA supports strict enforcement of locate and delivery rules that have been proven to substantially reduce illegal and abusive short selling, including naked shorts. We believe that Rule 204 has produced empirical evidence that the clearing and settlement function is the appropriate area on which to concentrate short sale regulations. Implementation and enforcement of Rule 204 has reduced the number of stocks on the threshold lists from 582 in July of 2008 to 63 issues one year later, a reduction of over 89%. Only a handful of the 63 stocks remaining on the threshold lists are actual operating companies, the balance are exchange traded funds (the mechanics of the creating and redeeming these funds is probably the cause for these fails).

We question the enforceability of Reg SHO Rule 203(b)(2) which “requires a broker-dealer, prior to effecting a short sale in any equity security, …[to have]… reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due”. The “reasonable grounds to believe” provision defies objective measurement and could provide an avenue to circumvent the intent of the locate rule. The “reasonableness” standard is even more impaired by the answer to question 4.1 in the Division of Market Regulation “Answers to Frequently asked Questions Concerning Regulation SHO” release regarding how broker/dealers should satisfy the reasonableness requirement. The division responds, ““Reasonableness” is determined based on the facts and circumstances of the particular

transaction. What is reasonable in one context may not be reasonable in another context." We believe that the Commission should tighten the abstract language in the rule and provide some concrete examples of how broker/dealers are expected to perform under this provision.

The STA recommends that the SEC undertake a review of Rule 203 of Regulation SHO and its interpretations to amend language and address any circumvention of the intent of the rule. Surgically altering that language and strict enforcement could provide significant results in the effort to control improper and abusive short selling, including naked short selling.

If the Commission believes that additional regulation is absolutely necessary, then the Association would suggest the Commission review our circuit breaker elected pre- borrow proposal sent May 4, 2009. In our letter, we suggest an alternative to the price tests being discussed, this alternative would require short sellers to pre borrow the shares to be sold short once the price of those shares dropped to the circuit breaker threshold (e.g. 10%). The pre-borrow requirement would include the appropriate exemptions including an exemption for bona fide market makers and options market makers until the price of the security declined further (e.g.20%), once that election level were touched the mandatory pre-borrow would apply to all short sales, no exemptions. And if the stock declined even further (e.g. 30%), short sales in that stock would be banned for the remainder of the day. The STA stands by our initial recommendation of clarifying existing regulation. If the Commission decided that additional short sale regulations were necessary to slow falling prices STA's alterative circuit breaker presents a viable solution.

While the circuit breaker pre-borrow proposal would be a reasonable alternative to short sale price tests, it may not be a reasonable alternative to Rules 203 and 204 in an effort to address naked short selling. Placing a mandatory pre-borrow requirement on a hard to borrow issue may restrict liquidity to an unreasonable degree and cause unwarranted price fluctuations in the issues trading. This could be very costly for investors purchasing the stock. Purchasing investors should not be required to pay for short sale regulation.

The costs /benefits analysis will be extremely important when considering imposing a market-wide mandatory pre-borrow requirement. Implementing a market wide permanent pre-borrow requirement would be very expensive. As we have mentioned in previous comments the breadth of the abusive short selling problem appears to be limited and market wide permanent solutions would inappropriately affect all market participants. Our circuit breaker pre-borrow would affect only those investors who were trading distressed securities, allowing all investors in non-distressed securities to participate in the price discovery process unfettered.

Some potential questions and important topics that should be discussed on the "**Contro**ls **on "Naked" Short Selling: Examination of Pre-Borrow and Hard Locate Requirements"** Panel are addressed below.

Should a Pre-Borrow or a Hard Locate be Considered?

The Security Traders Association recommends that if the Commission's goal is to slow abusive short selling, that is short selling on consecutive downticks, it should consider a pre-borrow requirement which would be triggered by a trading price circuit breaker instead of price test trading restrictions. As communicated to the commission in our May 4, 2009 letter the circuit breaker would work as follows:

All issues would trade without restriction until an issue touched a circuit breaker election level (X) from the issue's previous nights close. Once the election level is hit (e.g. 10%) all further short sales must pre-borrow stock. Thus, if stock ABC were to decline X from ABC's previous close (e.g. 10%) during a trading session, the securities information processor (SIP) would flag the issue as distressed. All shares to be sold short in the distressed issue from the time the SIP flags the issue as distressed until the issue opens in the next day's regular trading session must be borrowed prior to that short sale being executed. There would be exemptions for bona fide market makers, bona fide options market makers and international or domestic arbitrage scenarios from the mandatory pre-borrow between the previous close and level X+Y (e.g. 20%). Once the Circuit Breaker X+Y (e.g.20%), is reached, the mandatory pre-borrow would apply to all short sales, no exemptions. If the issue were to continue to decline at election level X+Y+Z (e.g.30%), a short sale ban for the remainder of the trading session would be implemented.

This circuit-breaker scenario would apply to individual securities on an issue by issue basis. It would become effective only after an issue reached the circuit-breaker election level and was flagged as distressed by the SIP, thus leaving overall markets to function normally. This proposal would only react when and where the regulation is needed.

Implementing this proposal as a prescriptive rule where the behavior is specifically not allowed would be more appropriate than implementing it as a principles-based rule. While principles-based rules are valuable in the fast-paced trading arena, the back-office side is a much more methodical environment where prescriptive rules work well. Once the SIP flags an issue as distressed, there would be a mandatory pre-borrow, no ifs, ands, or buts. If the participant cannot borrow the stock, then it would be illegal to execute a short sale.

If the Commissions wishes to address the "naked" short sale problem the circuit breaker pre-borrow approach could be adapted and the circuit breaker tied to the amount of fails to deliver that are present. This approach may prove to be more expensive than strengthening the current Rule 203 requirements or some form of a hard locate system which would decrement shares available to borrow on a real time share for share basis.

Benefits and Drawbacks of a Pre-Borrow or Hard Locate Requirement Must be Considered.

When a borrow agreement is entered into or a hard locate is received the stock available to borrow is decremented on a share for share basis resolving the multiple locate problem. Entering into the borrow agreement on trade date will eradicate any problems on settlement date because the shares will have already been pledged. This should also eradicate any "phantom shares" and associated problems created by multiple locates.

The process of entering into an enforceable borrow agreement prior to making any further short sales will provide the desired "timeout" or speed bump to slow trading in any distressed issue, giving time for rational participants to evaluate what price the issue should be trading at. This timeout period is actually scalable, as an issue becomes harder to borrow, the process of borrowing shares becomes more onerous and time consuming.

There is also a real and significant cost associated with entering into the borrowing agreement on trade date. Normally a short seller would locate shares to borrow, without any commitment to borrow those shares, on trade date and not enter into the borrowing agreement (commitment) until trade settlement.

Only when the short seller actually enters into the borrow agreement does he begin to pay for the borrowed shares. Forcing short sellers to enter into these borrow agreements three days earlier than they would normally borrow securities will change the profit/loss relationship of the proposed short sale, compelling less confident short sellers to abandon the trade and find greener pastures elsewhere, while allowing short sellers with conviction in their strategy to enter into the trade at a higher cost. Market participants understand the economics of trading and react quickly to avoid economic hardship; this proposal would literally hit them in the pocketbook. Quick-buck artists would be discouraged as their profits dwindled and other market participants would be unaware this was happening. The mandatory pre-borrow would also immediately reduce the pool of shares available to borrow, thus making an issue more difficult to borrow and raising the borrowing costs.

Since we proposed the circuit breaker pre-borrow requirement other commenters have commented that a pre-borrow requirement would significantly increase the costs of the short sale. We believe that the cost of short selling would increase, which is the deterrent discussed above. The proposed circuit breaker pre-borrow proposal would not be prohibitively expensive, however, because the restriction would only apply after the circuit breaker had been triggered. We also note that these costs would be borne by those engaged in short selling and not investors in general.

Would a Pre-Borrow or Hard Locate Requirement be Effective in Addressing Abusive "Naked" Short Selling?

A pre-borrow requirement has the potential to eradicate the naked short sale problem, but implementing a market wide permanent pre-borrow restriction would be expensive, both monetarily and with its affect on liquidity. Strict enforcement of Rule 204 has already produced significant results in the effort to clean up chronic fails to deliver and these efforts should continue. We would also suggest that surgically altering some of the language in Rule 203 of Regulation SHO would significantly address the problem of naked short selling without the expense of a pre-borrow requirement. If the Commission believes that more than a tightening of the Rule 203 locate requirements is necessary a hard locate system that decremented shares available to borrow on a share for share real time basis should be considered.

The SEC Should Consider All Options.

The Commission should consider any scenarios, regulations or automated systems that would rationalize the number of shares located with the number of shares available to borrow. These alternatives must be evaluated using a cost-benefit analysis, and the affect upon liquidity must be considered in those evaluations.

Any New Short Sale Restrictions Should be Implemented as a Pilot Program.

The STA has long held that the key to strong and efficient markets rests on the appropriate balance between regulation and competition. As regulations are developed they should be phased in to allow market participants to judge their effectiveness – how the new rules change the competitive dynamic and uncover any unintended consequences the new regulation may usher in. We further believe that it is more appropriate to attempt to accomplish the goals of regulation without disrupting the natural interaction of supply and demand or price discovery as much as possible.

The STA Circuit Breaker Pre-Borrow Proposal Would Be an Ideal Way to Implement a Pre-Borrow Pilot Program.

If the Commission did deem it necessary to implement a permanent pre-borrow requirement the circuit breaker pre-borrow would be an ideal method to pilot such a program. The circuit breaker pre-borrow method would concentrate the regulation on issues presumably experiencing high levels of short selling allowing the rest of the market to function as it was designed while helping the industry to work through any issues that would arise from the pre-borrow requirement.

If the Commission determines that a hard locate system is needed then the pilot issues should be selected from three buckets. The first bucket should contain issues that have had significant fails to deliver problems recently, the second should contain issues with significant short interest during the declines but were not hard to borrow and the third bucket should contain issues that have relatively low short interest and no delivery problems. Examining the affects of a hard locate on these three subsets of the market should provide reasonable cost and benefit estimates for the particular sub groups and help determine if the hard locate is desired or required on a market wide basis or would be better if it were applied in a more targeted fashion.

The Current Buy In Rule, Rule 204 has Proven Effective in Reducing "Fails to Deliver" and Discouraging Abusive "Naked" Short Sales.

The STA supports strict enforcement of locate and delivery rules that have been proven to substantially reduce illegal and abusive short selling, including naked shorts. We believe that Rule 204 has produced empirical evidence that the clearing and settlement function is the appropriate area on which to concentrate short sale regulations. The significant reduction in the number of issues experiencing chronic failures to deliver is a result of Rule 204. Implementation and enforcement of Rule 204 has reduced the number of stocks on the threshold lists from 582 in July of 2008 to 63 issues one year later, a reduction of over 89%. The STA specifically cites the effectiveness of Rule 204 in all three short sale comment letters we filed this year, however, there is a lack of attention to the success of the rule in the popular media.

Ways to improve the Current Regulatory Structure for Short Sales without Promulgating Additional Regulations

Rule 203 of Regulation SHO describes the requirements of the locate process. We believe that some of the abstract language in this rule has contributed to the abusive short selling problem, including naked short selling.

The STA questions the enforceability of Reg SHO Rule 203(b)(2) which "requires a broker-dealer, prior to effecting a short sale in any equity security, …[to have]… reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due". The "reasonable grounds to believe" provision defies objective measurement and could provide an avenue to circumvent the intent of the locate rule. The "reasonableness" standard is even more impaired by the answer to question 4.1 in the Division of Market Regulation "Answers to Frequently asked Questions Concerning Regulation SHO" release regarding how broker/dealers should satisfy the reasonableness requirement. The division responds that ""Reasonableness" is determined based on the facts and circumstances of the particular transaction. What is reasonable in one context may not be reasonable in another context." We believe that the Commission should tighten the abstract language in the rule and provide some concrete examples of how broker/dealers are expected to perform under this provision.

The STA also has concerns about whether the requirement of 203(b)(2) has been strictly complied with, namely that "The locate must be made and documented prior to effecting a short sale, regardless of whether the seller's short position may be closed out by purchasing securities the same day". The high volumes in "targeted" issues, some being over 100% of the current float of the issue, leads to the conclusion that more than the available number of shares are being traded. Extreme trading volumes occurring as fails to delivers have come down significantly lead us to believe that there must be significant intraday short selling activity that is either not locating shares to deliver or receiving one of multiple locates being issued on the same shares.

The STA recommends that the SEC undertake a review of Rule 203 of Regulation SHO and its interpretations to amend language and address any circumvention of the intent of the rule. Surgically altering that language and strict enforcement could provide significant results in the effort to control improper and abusive short selling.