

SEC Securities Lending and Short Sale Roundtable

Panel 1: Controls on "Naked" Short Selling: Examination of Pre-Borrow and Hard Locate Requirements

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We believe that the available evidence does not support the need for any form of pre-borrow or hard locate. The Government Accountability Office confirmed in its May 2009 Report on Regulation SHO that 99.9% of daily transactions in US equity securities, by dollar value, clear and settle within the standard three day settlement period.

This data confirms that that current regulations, including Rule 204 of Regulation SHO, are the most effective ways to control abusive short selling. Rule 204 requires clearance brokers to close-out any delivery requirement, including those resulting from short sale transactions, within the standard settlement period. Our review of CNS fail data suggests that fail rates have declined over 80% since the implementation of the mandatory close-out requirements.

The time and cost associated with a pre-borrow or hard locate requirement should be carefully considered if the objective is to increase timely settlement by only 0.1%.

Both pre-borrow and hard locate requirements will result in significant expense to the industry and its participants.

- At a minimum, a pre-borrow requires the funding of the borrow beginning on trade date, instead of settlement date. In this regard, it is important to note that short sale proceeds are not available to clearance brokers until settlement date, requiring the clearance brokers to fund the pre-borrow out of their own capital. For example, in the wake of July 15, 2008 SEC Emergency Order that resulted in preborrows on the 19 covered financial stocks, broker-dealer balance sheet impacts of up to \$2 billion to support preborrows were reported.
- Only a small percentage, estimated to be less than 5%, of all locates result in the need to borrow. Consequently, pre-borrows would needlessly drain supply from the securities lending market, which will result in reduced liquidity.
- The cost associated with short selling will rise. Pre-borrows or other reservations of stock will result in fees being paid by borrowers to lenders that will be passed along to short sellers.

- Both a pre-borrow and hard locate requirement would require significant infrastructure builds on the part of participants as well as the industry. For example, a hard locate concept that has been circulated would require every executing broker, clearing or prime broker, custodian, agent lender, and DTCC to build or modify systems

A pre-borrow or hard locate requirement can be expected to have minimal impact on abusive, naked short selling because an entity that engages in this activity does not comply with locate requirements nor does it seek to make delivery when it is due. Preborrow and hard locates serve to add cost and complexity that impacts those who are already complying with regulations.

The implementation of the mandatory close-out provision of Rule 204 has largely eliminated fails. That said, we recommend that the Commission move forward with the adoption of the revised Prime Brokerage No-Action Letter which has been submitted on behalf of the industry by SIFMA.

The framework outlined in this letter provides for enhanced monitoring of order marking (long versus short), customer positions to support long sales, and locates and requires communication between prime brokers and executing brokers when certain discrepancies are detected. In summary, Section 10 of the revised letter requires notification of order marking discrepancies (long vs. short). Section 11 requires the validation of positions on long sales. Section 12 requires the prime broker validate locates on short sales. Any discrepancy not resolved with the customer must be reported to the executing broker. The executing broker must consider this information in determining subsequent transactions with this customer.

These procedures are specifically targeted at ferreting out anyone who attempts to engage in abusive naked short selling.

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