

PREPARED STATEMENT OF TESTIMONY

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Good morning. I'd like to thank the Commission and the Staff for the opportunity to participate today on behalf of Direct Edge, the nation's third largest stock market.

The Commission's targeting of naked short selling through the passage of stringent locate, borrow and delivery requirements, such as Rule 204T, have yielded impressive results to date by drastically reducing the incidence of failures to deliver. The Office of Economic Analysis has noted that Fails to Deliver declined over eighty percent from their 2008 high to March 31, 2009, with further declines thereafter.¹ The average daily number of threshold list securities has declined over ninety percent from the July 2008 high. This data clearly suggests that the actions that the Commission has taken to date are working very well to target "naked" short selling. Yet potential initiatives for further improvement do exist.

At this juncture the Commission's focus should be on what measures would be cost-effective in further curtailing abuse, while making the process of short-sale delivery and settlement more efficient, and leveraging these efforts to rationalize the regulatory framework surrounding the locate and transaction process.

Our belief is that imposing a pre-borrow requirement for short sales would constitute an inefficient use of capital as such a requirement would force securities to be locked up in a customer's account for the three days preceding settlement. On the other hand, we believe that an examination of potential improvements to the locate process is warranted, particularly if it can mitigate some of the inefficiencies that exist in the current regulatory structure governing locates and improve coordination between custodians, executing brokers, market centers and regulators.

Today, when a customer executes and custodies their asset at the same broker – whether it be a retail investor with their broker or an institution with their prime broker - generally the custodial broker will decrement their available, lendable shares on a real time basis as part of the execution process. In such a scenario, a reliable "hard locate" is effectively obtained. The challenge in broader mandates for "hard" locates would appear to be achieving the same level of reliability for "away" locates – where the custodial and executing brokers are not the same -- to provide similar certainty on a cost-effective basis.

Reliability could be enhanced by improving trade date validation for locates through end of day reconciliations between the locate broker and the executing broker. Such an approach potentially enhances the reliability of “away” locates, exposes “naked” short sellers and facilitates inventory management of securities available for loan. Initiatives and processes that facilitate this warrant further examination, both with respect to their efficacy and potential for expansion.

Greater transparency for borrowing and lending transactions, with proper audit and compliance standards, also offer the potential benefit of enhanced reliability of “away” locates. In order to ensure consistent reliability, however, settlement would need to occur versus a central counterparty that could provide requisite guarantees of delivery. The existence of a central counterparty would greatly reduce the likelihood of fails to deliver occurring. Further, such market developments create an opportunity for integration of securities lending activity into the transaction process itself, alleviating systemic and regulatory risk.

Any regulatory initiatives, especially mandates, must heavily weigh their resultant costs. If properly constructed, regulation can make markets more efficient and allow for rationalization of certain short-sale regulation. Any further regulation of the locate process needs to consider that current short-sale regulation prompts “over location,” that is, locating more shares than a market participant actually intends to short on a net basis. Any inventory-management efforts grounded in locates run the risk of restricting the availability and cost of locates, potentially disrupting even net long or market-neutral trading strategies. Thus, any consideration of more stringent regulation will also need to consider how to alleviate some of the regulatory inefficiencies that will only be exacerbated by a closer correlation of located shares to shares sold short.

One potential tandem effort would be the extension of the “buy to cover” concept to all securities. Current Regulation SHO guidance requires a locate for each short sale of a “hard to borrow” security, regardless of whether a short seller has covered such shares through repurchase between such sales on an intraday basis. In a situation where a locate can be directly tied to actual shares to be used for delivery, there should be no distinction between hard to borrow and easy to borrow securities, as the locate serves to ensure delivery regardless. Additional further efforts to minimize the need for market participants to locate more securities than will actually be required for delivery on settlement, such as a broad re-evaluation of the role of a market maker or similar exemptions in today’s market structure, should also be considered. There are many scenarios where it may be appropriate to consider net economic position over transaction sequencing as the prime determinant for the appropriate level of locates within a trading day. With securities lending and short sale regulation co-ordinated in this fashion, the likelihood of investor benefit from greater confidence and a more efficient market will be optimized.

Once again, I’d like to thank the Commission for the opportunity and I look forward to a great discussion and any questions you may have for me.

¹ According to the fail to delivery data provided by the Commission, from March 31st to July 31st of this year, fails to deliver dropped by another 46% and kept dropping into August (<http://www.sec.gov/foia/docs/failsdata.htm>)