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VIA EMAIL AND U.S. MAIL

September 24, 2009

The Honorable Mary L. Shapiro
Chairman
Securities and Exchange Commission
100 F. Street, NE
Washington, DC 20549-1090

Dear Chairman Shapiro,

Overstock.com has always enjoyed a frank dialogue with SEC staff over Overstock.com's proposals to improve Regulation SHO, including implementation of a pre-borrow requirement¹. The problems that long persisted with Regulation SHO came suddenly to light in the events surrounding the market downturn of 2008, and Overstock.com continues to believe that the time for further improvement of Regulation SHO and putting an end to abusive naked short selling is now. In that vein, this letter sets forth (1) Overstock.com's proposals for what it believes is a very workable solution, specifically the imposition of a pilot pre-borrow program, and (2) questions that Overstock.com believes should be addressed at the September 30 pre-borrow roundtable.

Pre-Borrow Pilot Program – An Ideal Compromise Solution

The SEC continues to face a stern challenge in designing a regulatory answer to naked shorting and the continuing occurrence of so called "failures to deliver" ("FTDs"). The SEC has received many comment letters from issuers, economists, former regulators, and academics that urge the SEC to tighten Regulation SHO and institute a pre-borrow requirement or a hard locate rule so that shares are guaranteed to be available for settlement of short orders. Proponents of a pre-borrow requirement point out that massive amounts of FTDs contributed to the disorderly demise Lehman Brothers and Bear Stearns and the resulting shock to global markets in 2008 and note

¹ See, for example, the comments submitted by Overstock.com on June 23, 2009 at <http://www.sec.gov/comments/s7-08-09/s70809-3984.pdf>, May 29, 2009 at <http://www.sec.gov/comments/s7-08-09/s70809-2850.pdf>, August 22, 2008 at <http://www.sec.gov/comments/s7-19-07/s71907-1359.pdf>, July 23, 2008 at <http://www.sec.gov/comments/s7-20-08/s72008-179.pdf>, October 1, 2007 at <http://www.sec.gov/comments/s7-19-07/s71907-303.pdf>, September 10, 2007 at <http://www.sec.gov/comments/s7-19-07/s71907-130.pdf>, April 19, 2007 at <http://www.sec.gov/comments/s7-12-06/s71206-807.pdf>, and September 11, 2006 at <http://www.sec.gov/comments/s7-12-06/s71206-196.pdf>, and notes of meetings between Overstock.com representatives and Commission staff on September 8, 2008 at <http://www.sec.gov/comments/s7-19-07/s71907-1436.pdf>, July 11, 2008 at <http://www.sec.gov/comments/s7-19-07/s71907-682.pdf>, and November 16, 2007 at <http://www.sec.gov/comments/s7-19-07/s71907-336.pdf>.

that while the current levels of FTDs has decreased, nothing prevents them from recurring in the future². FTDs and naked short selling have often been used in instances of market manipulation to drive share price down rapidly. Several members of Congress have repeatedly urged the SEC to institute a pre-borrow rule and have questioned you on the subject in hearings and letters. To the contrary, the securities industry in general opposes a pre-borrow requirement and has made claims that a pre-borrow requirement or hard locate rule will interfere with the efficient operation of the markets.

The SEC faces a difficult environment in the wake of the financial crisis of 2008. Almost a year later, distinguished economists have described the U.S. markets as continuing to be fragile. With the efficiencies of high-speed electronic trading, the potential remains high, they argue, for another major public company in any industry to suffer the fate of Lehman Brothers and Bear Stearns, creating another major trauma to the markets and the financial system. Should such a failure occur again, the public and Congress may well hold the SEC accountable and ask, “Why did the SEC not take action to protect the markets?”

Overstock.com believes that, fortunately, there is an ideal compromise that the SEC can take immediately that will satisfy the arguments of both those who support a pre-borrow requirement and those who oppose it: the SEC should establish a pre-borrow pilot program in which public companies can participate on a voluntary basis to study both whether a pre-borrow requirement will effectively eliminate naked short selling and FTDs. The SEC’s Office of Economic Analysis could monitor the pre-borrow pilot and collect and study the data to determine whether these approaches are effective and whether any negative impact occurs to the markets. The data from this pre-borrow pilot program should be made available publicly to allow analysts and economists to perform their own studies of the data, thereby assisting the SEC. This approach would be prudent and protect the overall markets, while offering a step forward to the proponents of a pre-borrow rule, including the members of Congress, who fear the impact of naked short selling and FTDs. Such an approach should determine objectively once and for all, whether a pre-borrow requirement works in the U.S. markets and whether any harm is posed. Overstock.com cannot understand why there would be any honest objections to such a pre-borrow pilot program.

Important Elements of a New Pre-Borrow Pilot Program

Pursuant to the SEC’s power to establish a pre-borrow pilot program under Rule 202T of Regulation SHO, the SEC should establish a pre-borrow pilot program to evaluate the effectiveness of a pre-borrow requirement on the financial system. The goal of the pre-borrow pilot program would be to gather trade data and measure the impact of a pre-borrow requirement on market liquidity, trading volume, the amount of legal short selling, the amount of FTDs, and borrow rates in the market. Such a pre-borrow pilot program is in the public interest because it will assist the SEC to assess whether further changes to short sale regulation, such as a

² See, for example the study entitled “The Impact of a Pre-Borrow Requirement for Short Sales on Failures-to-Deliver and Market Liquidity” by Drs. Robert J. Shapiro and Nam D. Pham which Overstock.com has previously provided to the SEC at <http://www.sec.gov/comments/s7-08-09/s70809-2850.pdf>.

mandatory pre-borrow requirement, are necessary in light of current market practices and the purposes underlying short sale regulation.

- **Modified Rule:** Similar to the July 2008 Emergency Order, the pre-borrow requirement would prohibit any person from effecting a short sale unless the person has borrowed or contractually arranged to borrow the security or otherwise has the security available to borrow in its inventory prior to effecting such short sale, and can deliver it at settlement. The key difference from the current status quo is that the security must be “locked up” in a private contract and it will not be sufficient to “hard locate” available shares in a central clearing network. A mandatory pre-borrow requirement may be implemented by amending Section 203(b) of Regulation SHO to read: “A broker or dealer may not accept a short sale order in an equity security from another person, or affect a short sale in an equity security for its own account, unless the broker or dealer has: (i) Borrowed the security, or entered into a bona-fide contractual arrangement to borrow the security; and (ii) Documented compliance with this paragraph (b)(1) with proof that it has the contractual right to borrow including a right to borrow on an automated stock loan facility which guarantees delivery.”
- **Term:** The pre-borrow pilot program should run for 24 months to ensure that adequate empirical data is collected and to increase the likelihood that the program runs through both a bull and bear market. The SEC could always modify the term as it determines to be necessary or appropriate in the public interest or for the protection of investors. An alternative approach would be to adopt a modified Section 203(b), as described above, with a sunset provision at 24 months.
- **Participants:** The pre-borrow pilot program should have some mandatory participants and should also allow any company, provided it is traded on a national securities exchange, to opt-in to the program. In order to obtain not only a meaningful sample size, but also a relevant sample, the mandatory participants should include the 250 companies that have appeared on the Regulation SHO threshold list the most trading days since January 2005. Analyzing the effects of a pre-borrow requirement on these companies in particular will be helpful because, although not conclusive evidence of abusive naked short selling, their consistent appearance on the threshold list is a good indicator that they have been affected by abusive naked short selling in the past. It may also make sense for the SEC to include a mix of WKSIs, mid-caps, small-caps, penny-stock companies in the pre-borrow pilot program.
- **Data Collection:** Much like the tick test pilot program in 2005, the SEC’s Office of Economic Analysis should monitor the progress of the program and evaluate information received from each of the exchanges and self-regulatory organizations on a regular basis. The relevant empirical data to be examined would be the (i) increase or decrease in FTDs for the pilot securities compared to non-pilot securities, (ii) impact on overall market liquidity, (iii) increase or decrease in legal short selling, and (iv) impact on borrow rates. The collected data should be helpful in assisting the SEC make an informed decision regarding a mandatory pre-borrow requirement. Further, the SEC should use this

opportunity to disclose the data to the public. Doing so would both support its mission of promoting market transparency and engage experienced academics and professionals in examining the prudence of a pre-borrow requirement.

Questions for the September 30 Pre-Borrow Roundtable

It has been reported to me that the SEC may decline my August 24, 2009 request to participate in the September 30 pre-borrow roundtable because Overstock.com's viewpoint on this important subject is too well known to be worth including on the panel. If that is the case, I am deeply disappointed. Overstock.com has led the fight against naked short selling for more than four years. Overstock.com has had considerable experience with Regulation SHO and has insights into the issues that the Commissioners will consider at the pre-borrow roundtable. These insights would help to provide you and your colleagues with a full understanding of the conflicting viewpoints on a possible pre-borrow requirement. While Overstock.com's position may be well known, Overstock.com's participation in the roundtable would enable a free exchange of ideas with those who take a different position. The promise of the free-exchange of ideas proposed in the form of a roundtable is that it will yield meaningful reform. Therefore, I respectfully renew my request that the SEC allow me to participate as a panelist in the pre-borrow portion of the September 30 roundtable.

Regardless of whether Overstock.com is able to participate in the September 30 pre-borrow roundtable, Overstock.com respectfully suggests that the roundtable participants address the following questions:

1. Though Rule 204T has done much to limit naked short selling, it is still possible to fail to deliver en masse (and cover) within the three-day settlement window. Furthermore, companies continue to appear on the Regulation SHO threshold list. In a recent report, Drs. Robert Shapiro and Nam Pham found that a pre-borrow requirement for short sales would not damage market liquidity. Given those three facts, what are the specific reasons why the SEC should not adopt a pre-borrow requirement?
2. While recent past SEC actions to tighten Regulation SHO have been beneficial in terms of reducing the number of companies on the Regulation SHO threshold lists, would you agree that the absence of a pre-borrow requirement leaves open the door to future rounds of naked short bear selling attacks when market conditions are more favorable?
3. In most cases, Regulation SHO allows a short seller to "locate" (and not pre-borrow) shares prior to executing a short sale. What happens if a locate is fraudulent? Who is culpable? Does Rule 10b-21 mitigate all prime broker liability in the case of repeated bad locates?
4. Would not a pre-borrow requirement for short sales be easier to document and enforce than the current locate requirements?

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5. Can you clarify the responsibilities of FINRA and the SEC with respect to investigating abusive short selling?
6. What do you recommend should be the SEC's position on the DTCC's offer to tag locates? How would that work in terms of insuring a completed, documentable borrow?
7. On July 29, 2009, the SEC's Investment Advisory Committee published a long list of action items (<http://www.sec.gov/news/press/2009/2009-175.htm>). Do you believe that abusive short selling and settlement failures should have been on that list?
8. Rule 204T requires that a broker-dealer "buy-in" shares in order to "close out" an outstanding fail to deliver position. How does a "buy-in" work? Who audits broker/dealer books to confirm a "buy-in" has occurred? What role should the SEC have?
9. Isn't it possible to work around a "tick test" (or any other price test) merely by creating synthetic short trades through derivatives? Example: Short sellers can buy married puts from options market makers as described in the recent enforcement actions against Hazan Capital Management and TJM Proprietary Trading.

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Thank you for your consideration of Overstock.com's suggested pre-borrow pilot program, my renewed request to participate on the September 30 pre-borrow roundtable, and the suggested questions to panelists on the September 30 pre-borrow roundtable.

Sincerely,



Jonathan E. Johnson III
President

cc: The Honorable Luis A. Aguilar, Securities and Exchange Commission
The Honorable Kathleen L. Casey, Securities and Exchange Commission
The Honorable Troy A. Paredes, Securities and Exchange Commission
The Honorable Elisse B. Walter, Securities and Exchange Commission