

The International Association of Small Broker Dealers and Advisors

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The International Association of Small Broker-Dealers and Advisors, www.iasbda.com <<http://www.iasbda.com>>, submits the following comments on the above referenced proposal to finally deal with the locate loophole, the mother of all loopholes. The commission has chosen to do this thru a hard close rule instead of an initial pre-borrow requirement. We think both are needed and address them separately herein.

1) The locate rule is no rule at all.

We believe this issue is poorly understood and is often sensationalized, misunderstood and conflated with other short selling issues. We believe there are five basic issues that demand that the concept be eliminated in favor of a firm locate or pre-borrow:

- It does not require a continuing effort to find the stock but only a glance at an easy to borrow list that is not decremented or reduced for stock loan commitments;
- It therefore provides a perverse means of achieving the opposite of what is intended. Its more profitable for the locate to fail as the short seller has no borrowing costs;
- It has been dumbed down over the years to its lowest possible requirement so that a broker can rely on a client who can rely on a list that like the airlines can book more seats than it has. At one time a hard to borrow list was also available leaving open only the need for a medium to borrow list.
- Its confusing to the investing public who believe that it has more strength than it really does;
- It encourages opportunistic short selling by providing an easy way of profiting in a crisis situation with little fear of enforcement because of its subjective requirements. In other words violations are hard to prove.

The biggest argument to continue to locate is the fact that not all short sells complete and the borrow may be unnecessary. We have always believed the firms involved will work out this problem, so that the fees for a loan not needed will be reduced in return for future business. While the supply of stock available will be impacted, we believe the industry will adjust to this also. Firms will have an incentive not to over locate which is now the common practice and they will have an incentive to inform the lender as soon as possible that the stock is not needed and may diverted to another short seller. But even if supply is impacted as SEC Chairman James Landis once noted liquidity is not an excuse for less effective regulation and Chairman Donaldson once noted that you shouldn't trade fraud for liquidity. The Commission could consider allowing locates to remain for the most liquid stocks and using its emergency power to invoke it when necessary. However we believe the opposite may be a better approach, i.e. to require firm locates or pre-borrows but use its emergency powers to lessen if the need arises.

2) The Hard Close (HC) alternative must also include an initial pre-borrow.

Rather than address the locate rule, the proposal seeks to bypass it by requiring that participants of a clearing agency registered with the Commission "to deliver securities by settlement date, or if the participants have not delivered shares by settlement date, immediately purchase or borrow securities to close out the fail to deliver position by no later than the beginning of regular trading hours on the settlement day following the day the participant incurred the fail to deliver position." This alternative is really a mandatory buy-in rule that seems directed to the seller and buyer rather than the prime broker/institutional lender who has failed to provide the borrowed stock. A short seller has a duty to locate stock and can do so thru the selling broker, its prime broker or thru an easy to borrow list. The seller can acting in good faith perform the locate but not receive the borrow. The HC rule then penalizes the seller and clearing firm by requiring a buy-in. But it's the lender who caused the problem presumably because it failed to decrement its positions. At the very least decrementing should be required. Furthermore if the clearing firm is net long at NSCC on the day in question no one is penalized and if the buy-in occurs without guaranteed delivery another fail is created. Finally the seller will have 3-5 days to execute an opportunistic naked short and may go to another broker to execute. More over if he chooses not to disclose his HC failure. at the first firm, he can repeat the manipulative process.

The commission often uses the buy-in remedy as a post trade solution. But if the buy-in results in a loss the executing entity must pursue that loss against the party failing to deliver. It is an imperfect remedy that in this case as in others comes after the damage is done. On the other hand a pre-borrow puts the lender at risk if it cannot deliver by giving the borrower/ short seller a clear contractual cause of action for fixed damages. "The pre-borrow requirement is designed to ensure that securities will be timely delivered for settlement of a short sale. In a pre-borrow arrangement, the lender confirms to the borrower that shares are available for timely delivery and affirmatively agrees to reserve the shares for exclusive use by the borrower" <http://www.leksecurities.com>.

Currently regulations require that a short seller have "reasonable grounds to believe that the security can be borrowed." Observers expect that the commission will tighten that requirement, calling for a borrowing agreement to be in place before selling short. Although some broker-dealers pre-borrow securities for their customers to short, that tends to be a more expensive option. "For easy-to-borrow securities--typically highly liquid stocks from large-cap issuers including many of the financial firms under recent pressure--short sellers can use as "locates" lists of stocks, issued by custodians before the beginning of the trading day. However, a bona-fide arrangement to borrow, according to the commission, requires that "the security being borrowed is set aside at the time of the arrangement solely for the person requesting the security, also known as decrementing." **EquiLend, SunGard Aim to Support Short Selling Mandates October 7, 2008 By John Hintze.** Thus the distinction between the initial pre-borrow and that proposed is as follows:

- A pre-borrow requirement focuses on the front end of the trade and would

ensure that *no* trade would result in a failure-to-deliver; a hard delivery requirement focuses on the back end of the trade and creates a period ripe for fraud. I suspect this is why theatres require patrons to present a ticket prior to entering the show, rather than allow them to watch the show and deliver a ticket five days later.

- A hard delivery requirement still allows for an intra-period raid (the period

would be a day if the hard delivery period was T+1 or a week if the hard delivery requirement was T+5). A trader (day trader, market maker, etc.) could raid a stock on naked short sales and cover under the panic sell that day. Without a pre-borrow requirement, a naked short selling trader never engages in a borrow so long as he covers during the required period. Having no pre-borrow allows the trader to sell as many shares as he likes, so long as he covers within the hard delivery period. There is a lot that can be masked by such trading activities, especially by hedge funds with the financial firepower to use fast trading techniques to create the panic selling into a profitable cover.

Letter to Eric Sirri from Jon Johnson July 23,2008

We also believe the commission should make very clear what it means by a pre-borrow since it has not defined it fully in its past references and it should clearly define it as a binding contract. One perceived advantage of the pre borrow is that it provides an objective standard for enforcement as opposed to the current reasonableness test. We believe that the enforcement department in particular is weary of proving reasonableness in a proceeding. A pre-borrow defined as a contract is either present or not. On the other hand if its nothing more than an enhanced locate that also should be defined.

We therefore question whether the Commission can claim it has done everything to solve the abusive short selling problem without at least explaining why the initial pre- borrow remains such an elusive remedy other than industry resistance. While a hard close is a good incremental approach, the current crisis demands the end of incrementalism. The Commission should add an initial pre-borrow requirement to the interim rule in its final adoption of the rule instead of the locate requirement.

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