

Commissioners,

I run a small statistical arbitrage hedge fund that trades something like 1 million shares a day. We provide a substantial amount of liquidity in hundreds of stocks. As part of our strategy we take an equal dollar position long one security and short another security. Thus we have minimal aggregate price impact on the market. The execution of our strategy has become much more difficult with the recent rule changes, specifically rule 204T. It is not uncommon for us to have hundreds of thousands of dollars of short positions bought in due to the inability of our broker to locate shares for loan to settle our short positions on T+3 settlement day. Our broker is the largest independent broker in the United States.

Market Impact: What happens when I get a substantial short position bought in? In the next trading session, I have to SELL the equivalent dollar amount of the security that I am long. In some thinly traded issues, this could mean that I have to dump up to half the daily average volume of a stock onto the market. This has the effect of artificially depressing the price for that stock, and in these days of automated momentum trading, that motion could carry through for further trading sessions. In any event it distorts what would otherwise be the equilibrium price for the stock.

The rule seeks to address abusive naked short selling. We do not engage in abusive naked short selling. Yet we are substantially and adversely affected by the imposition of the rule.

The failure to deliver on the securities we are short that is the mechanical nub of naked short selling that is sought to be cured is the result of the historical but anachronistic framework for stock loans that has arisen over the last 30 years or more. In an ideal world, failure to deliver would be cured not by the imposition of anachronistic rules on top of an anachronistic mechanism for effecting short sales, but by having a more reasonable mechanism for short sales of exchange traded equity securities.

In the current state of affairs, what happens when I establish a short position? When I sell a stock I do not own to another party, my broker has to borrow the shares to supply them to the purchasing party on the settlement date. What that means is that either my broker has to lend me shares held by their other customers, or they have to contact one of the other innumerable broker/dealers in the market to ask if they have shares available for loan, either by phone or by consulting some other aggregated electronic posting which may or may not be accurate. An entire industry has grown up to satisfy this need. Nevertheless, my broker, the largest broker in the country, has enormous difficulty finding shares of securities that have ample public float, ample float in institutional hands and only a few percent of that float already short. Something is terribly wrong with such a system. Why is the system this way? In an age when people and institutions actually held paper certificates at the offices of their broker, this really might have been only way to do this.

But in the current day, almost none of the shares of a company are held as paper certificates. They are all held in electronic book form. The DTC knows nearly everyone who has nearly every position in almost every security. What would it take to mandate a central repository of this data and a central method for effecting short sales?

Here is how it might work. Suppose there are 100 million publicly floated shares of Company XYZ. When someone wishes to short XYZ, their broker should merely be able to look up whether there are shares ANYWHERE available for borrowing and put a lock in on the necessary number of shares at the central clearing location. Everyone who holds their shares in electronic book form would be presumed to consent to their shares being borrowed. Unlike in commodities trading, where a new short position can just result in an increase in open interest (a new contract being generated sui generis), there is an actual upper limit on the number of shares of a stock that can be shorted. That theoretical limit is the public float.

Of course in practice, the number of shares available for short sale may be less than the entire float. The primary reason is that the lender of shares may need to have the shares to vote in a shareholders vote. And a lender of shares must give up the right to vote because the downstream purchaser must have those rights and each share can only be voted once. But for any given security, the number of shares actually voted in any shareholder vote is almost without exception, a tiny fraction of the number that could vote. And so you might reserve some number of the public float such that they are not available for short sale, either on the basis of a statistical review of the number of shares that typically vote for any given security, or by means of some other heuristic. This reserve could be more than half the public float (a number of shares orders of magnitude in excess of what is usually voted) and still not make a difference for short sales, as the percentage of the float usually short is typically much smaller than half.

The only other issue relates to borrowing fees and the vested interests supported thereby. Either these fees can be standardized, or some algorithmic solution can be found. That some businesses might be impacted by making the stock loan market operate in a manner more consonant with public policy is unfortunate but necessary. The benefits would far outweigh the costs and dislocations.

By moving the stock loan system toward something more in line with the modern automated and computerized world, the Commission can increase transparency and certainty in the market related to short sales, maximize market efficiency and eliminate the naked short sale problem caused by delivery failure with minimal impact to market participants. I urge the Commission to initiate research into how such a successor stock loan system can be effected in the US marketplace and that our markets can continue to serve as an example to markets globally.

Respectfully,

Thomas Bergerson