SPITALFIELDS ADVISORS

A Review of The Securities and Exchange Commission's (SEC) emergency order concerning "naked" short selling

Executive Summary

Did the emergency rule work?

The motivation behind the SEC's recent rule change was to curb "naked short selling". The SEC's order required that anyone effecting a short sale in these securities arrange beforehand to borrow the securities and deliver them at settlement. The order took effect on Monday, 21st July. In addition to this emergency order, the SEC proposed to undertake a rulemaking to address these issues across the entire market.

But where was the proof that naked short selling was widespread? The Depository Trust & Clearing Corporation (DTCC) should know, and their official comment is that its scale is in dispute. Spitalfields Advisors, an independent consultancy firm to the securities lending industry, estimate that there is $5 trillion worth of stocks being borrowed globally every day - mainly to cover short positions. We would argue that naked short selling is a rounding error. It was politically convenient to be seen to do something to protect elements of the financial system that seemed to be under attack and to prevent the possibility of a repeat of the Bear Stearns collapse.

What was the impact of the SEC rule change? The main result was a dramatic surge in the volume of securities borrowing as broker dealers made sure they complied to the letter of the new regulation. The announcement of the emergency rule also coincided with rebound in the share prices of US banks. Was this because people covered their naked shorts or was it because this drastic action caused people to think that the 21st July ruling represented as low as bank shares could fall, thereby causing more buyers than sellers? We may never know for sure but other factors worth considering are a fall in the price of oil, the rising US dollar and better than expected earnings from Wells Fargo and Bank of America in particular.

One of the unintended consequences of the emergency rule was a surge in "over borrowing," and the cost of this to the prime brokerage departments of broker dealers was very significant. Instead of borrowing securities on a net basis when they were required for settlement date, the prime brokers were borrowing gross volumes of securities in anticipation of being asked to short them by their hedge fund clients. The over borrowing levels put additional pressure upon the already strained balance sheets of the prime brokers – many of whom are ironically on the SEC 19 list.

Whatever anyone says, short selling is here to stay. It is part of the efficient working of the market place, allowing informed investment of capital by fund managers. As we will explain, the surge in borrowing activity was due to the prime brokers and their clients taking an extremely cautious approach to the implementation of the emergency rule. As one prime broker said: "The cost of borrowing $100m worth of securities pales into insignificance compared to the prospect of being on the front page of The Wall Street Journal for breaking the emergency rule. Or put it another way - it only costs $27 per day to borrow $1,000,000 of a security at a 1% fee."

So what should happen now?

After a period of reflection and consultation, the SEC is widely expected to introduce regulations to address perceived problems and restrict inappropriate behaviour. We favour several distinct courses of action and outline them briefly below: -

Enforce stricter buy-in procedures and dramatically reduce the permissible fail to deliver period. This would have the beneficial impact of penalising those unable to deliver securities and ensure that short sellers must have access to borrowed securities to facilitate settlement. Allowing a 13-day grace period is not in the best interest of an efficient market. This practice is commonplace in the international markets and it is quite surprising that the US seems so tolerant of settlement inefficiencies. Trades should be closed out and bought in after T+5 and a published list of outstanding transactions should be monitored and made publically traded. Trades were liquidity (or the lack thereof) prohibits settlement should be unwound.

The settlement and operational issues associated with the options market (and in particular the options market makers) deserves scrutiny, and we would expect the Bear Stearns post mortem to highlight the options market in particular. Firm settlement and buy-in procedures are urgently required to ensure that position keeping is accurate, and fails to deliver are reduced. There are structural problems with the options market that can exacerbate the instances of naked short trading. Some might claim ignorance of their settled position - but ignorance is no defence.

The regulators should look in detail at the intra-day naked short selling problem up front (I.e. when it is not necessarily likely to result in any actual fail to deliver) and in particular, review the margin requirements for day trading. Increasing the capital requirements on this type of trading activity could reduce intraday naked shorts.

The US purpose test should be removed, as it has been widely in the international markets. This would enable the providers of short side liquidity - the prime brokers to borrow securities in anticipation of future demand and use treasury style liquidity management techniques. We would also suggest that controls are put in place to complement basic economics as an impediment to any abuse. This recommendation is controversial and flies in the face of the prevailing regulatory mood, but the highly regulated prime brokers can - as they showed during the albeit short emergency regime – be trusted to heed the SEC.

The ability of the securities lending market to facilitate rock solid contractual and deliverable securities without having to actually borrow and collateralise the shares until actually needed and borrowed holds the key. It is unrealistic for prime brokers to pre - collateralize the market - they really don’t have the capital available - certainly not now.

Some of the prime brokers have recently taken the view that any exclusively available inventory is good enough to meet pre-borrowing regulations - others are requiring the lending agent to segregate securities sufficient to meet their order. This situation needs clarifying.

Effectively, a contractually enforceable option to borrow market is developing and must do so - with a key focus on reliable and enforceable delivery.

The re-introduction of the up-tick rule is not necessary or practical as the decimalization of the markets has removed the economic power of this ancient legislation.

We hope that you enjoy the paper and would very much welcome your feedback sent to mark.faulkner@spitalfieldsadvisors.com

Introduction

In recent months, the financial headlines have been full of articles on short selling, and in particular naked short selling and securities lending. Some of the copy has been well informed and balanced – some has not. The subject is a complex one and the temptation is for non experts to reach simple conclusions that are often inaccurate. The discussion is often hampered by a lack of transparency and detailed information and in this information vacuum, supposition, prejudice and dogma run rampant.

Regulators as far a field as Australia, the UK and the US have taken action, which has impacted their markets for a wide variety of reasons. The Australian market has experienced margin lending related defaults, the UK has seen significant difficulties with financial rights issues and the US has grown increasingly concerned with alleged market abuse and manipulation related to naked short selling. Inevitably the regulators have responded in a quasi political/economic manner rather than a pure economic way. This is to be expected - after all we live in the real world, not an economic model. Sometimes it is more important to be seen to be doing something rather than necessarily taking the time to do the right thing. In this paper we will focus upon the recent regulatory changes in the US market. A detailed analysis of the UK and Australian markets may follow in due course.

Background

It would be easy to see the recent US regulatory change as a one-off experiment conducted in response to unique circumstances. However, on closer examination the situation in the US is more complicated, and we would argue that it is worthwhile examining some of the key historic components that have affected the market as well as exploring the impact of the most recent events. This is a market undergoing regulatory evolution; not regulatory revolution.

The Emergency Order

On July 15th 2008, The Securities and Exchange Commission ("SEC") issued an emergency order to enhance investor protections against "naked" short selling in the securities of Fannie Mae, Freddie Mac, and primary dealers at commercial and investment banks.

Below we have listed the securities identified in the Commission's order that we shall call the "SEC 19" in this paper. We have also identified their country of incorporation to focus the reader upon the primary listing. As the reader will see, this is important because the emergency ruling had, as might be expected, more impact upon those securities whose primary listing was in the US compared to those with a primary listing overseas.

In the appendix we provide daily data from Data Explorers showing how the percentage of market capitalisation on loan changed on a daily basis and the market price of the security over the last 6 months - and critically over the timeframe of the announcement of the emergency order and its conclusion.

Company	**Country of Incorporation**
BNP Paribas Securities Corp.	France
Bank of America Corporation	US
Barclays PLC	UK
Citigroup, Inc.	US
Credit Suisse Group	Swiss
Daiwa Securities Group, Inc.	Japan
Deutsche Bank Group AG	Germany
Allianz SE	Germany
Goldman, Sachs Group, Inc.	US
Royal Bank	UK
HSBC Holdings PLC	UK
J. P. Morgan Chase & Co.	US
Lehman Brothers Holdings, Inc.	US
Merrill Lynch & Co., Inc.	US
Mizuho Financial Group, Inc.	Japan
Morgan Stanley	US
UBS AG	Switzerland
Freddie Mac	US
Fannie Mae	US

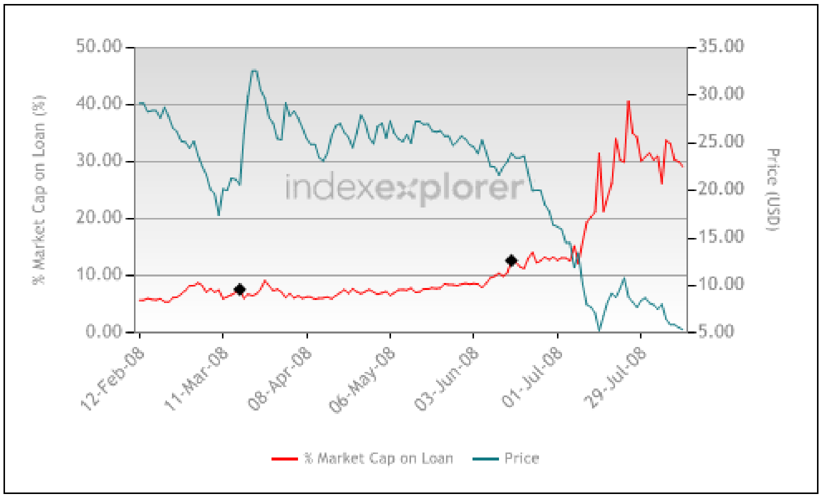
The SEC's order required that anyone effecting a short sale in these securities arrange beforehand to borrow the securities and deliver them at settlement. The order took effect on Monday, 21st July. In addition to this emergency order, the SEC proposed to undertake a rulemaking to address these issues across the entire market.

"The SEC's mission to protect investors, maintain orderly markets, and promote capital formation is more important now than it has ever been," said SEC Chairman Christopher Cox. "Today's Commission action aims to stop unlawful manipulation through 'naked' short selling that threatens the stability of financial institutions. We will continue our vigorous commitment to investors by working within the SEC and in close cooperation with our regulatory counterparts to promote the continued health and vibrancy of our markets."

The Commission's emergency order terminated on July 29th. The Commission extended the order until 12th August, having determined that the continuation of the order is necessary in the public interest and for the protection of investors.

The graph below of Freddie Mac demonstrates how the announcement of the emergency rule had a dramatic impact upon securities lending activity – an impact that all the SEC 19 shares underwent to a greater or lesser extent.

Freddie Mac



"Naked shorting"

"Naked shorting", as defined by the SEC, is where the short-seller does not borrow or arrange to borrow the securities in time to make delivery to the buyer within the standard three-day settlement period. As a result, the seller fails to deliver securities to the buyer when delivery is due; this is known as a "failure to deliver" or "fail."

The scale of "naked shorting" is in dispute, but if any organisation has an insight into the practice in the US it is The Depository Trust & Clearing Corporation (DTCC). The DTCC provides clearing, settlement and information services for a range of securities. A Q&A on naked short selling at www.dtcc.com is worth a visit. "While naked short selling occurs," says *DTCC* First Deputy General Counsel Larry Thompson in the document, "the extent to which it occurs is in dispute." He goes on to say that "…I also don't believe that there is the huge, systemic, illegal naked shorting that some have charged is going on. To say that there are trillions of dollars involved in this is ridiculous. The fact is that fails to deliver, as a percentage of total trading, haven't changed in the last 10 years." He estimates the current scale of fails to deliver to be about 24,000 transactions (out of 23 million daily) or about \$6 billion (1.5% of \$400 billion) and points out 20% of the fails are resolved via the DTCC Stock Borrowing program.

Regulation SHO

The emergency measures regarding the 19 securities effectively made them what are known as threshold securities, and bring them into line with the existing Regulation

SHO. Compliance with Regulation SHO began on January 3, 2005. Regulation SHO was adopted to update short sale regulation in light of numerous market developments since short sale regulation was first adopted in 1938. According to the SEC, some of the goals of Regulation SHO included establishing uniform "locate" and "close-out" requirements in order to address problems associated with failures to deliver, including potentially abusive "naked" short selling.

The “Locate” Requirement: Regulation SHO requires a broker-dealer to have reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date of delivery is due before effecting a short sale order in any equity security. This "locate" must be made and documented prior to effecting the short sale.

The "Close-out" Requirement: Regulation SHO imposes additional delivery requirements on broker-dealers for securities in which there are a relatively substantial number of extended delivery failures at a registered clearing agency ("threshold securities"). For instance, with limited exception, Regulation SHO requires brokers and dealers that are participants of a registered clearing agency to take action to "close-out" fail to deliver positions ("open fails") in threshold securities that have persisted for 13 consecutive settlement days. Closing out requires the broker or dealer to purchase securities of like kind and quantity. Until the position is closed out, the broker or dealer and any broker or dealer for which it clears transactions (for example, an introducing broker) may not effect further short sales in that threshold security without borrowing or entering into a bona fide agreement to borrow the security (known as the "pre-borrowing" requirement).

“The Uptick Rule”

The “uptick rule” in the US was a securities trading rule used to regulate short selling. The rule mandates that, subject to certain exceptions, a listed security may be sold short at a price above the price at which the immediately preceding sale was affected, or at the last sale price if it is higher than the last different price. In 1938, the SEC adopted the uptick rule after conducting an inquiry into the effects of concentrated short selling during the market break of 1937.

After a temporary suspension the SEC eliminated the uptick rule on July 6, 2007. The SEC's Office of Economic Analysis and academic researchers provided the SEC with analysis of the data obtained during the temporary suspension. The general consensus was against the uptick rule, with the commission concluding that the uptick rule “modestly reduce[d] liquidity and do[es] not appear necessary to prevent manipulation.”

The SEC motivation

We already know that the SEC’s stated objective when introducing the emergency order was to “stop unlawful manipulation through 'naked' short selling that threatens the stability of financial institutions." Speaking on 19th August SEC Chairman Christopher Cox said that their future proposal "will focus on market-wide solutions" but is not intended to have any impact on the direction of prices. Cox also said fails to deliver "were reduced substantially" for the stocks covered under the SEC's recent emergency short selling rule. "It was a very effective order from that standpoint," Cox said.

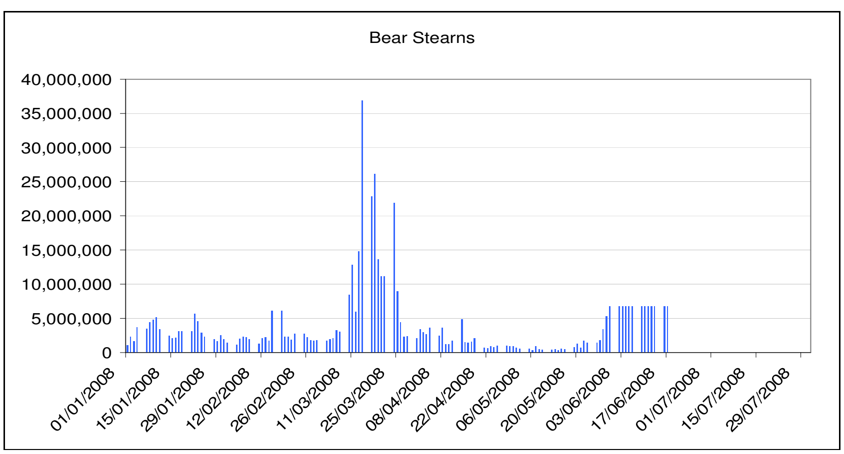
In July there was grave concern that some of the major US financial institutions had come under attack and needed defending. Seen against a backdrop of the Bear Stearns collapse, falling markets and collapsing share prices in the US financial sector it is easy to see why there was a call to action. The questions that really need answering, given the action taken by the SEC, are whether it was justified. Moreover, how effective was it? What should be done in the future?

The Purpose of this Paper

The purpose of this paper is to reflect upon the impact of this emergency order upon the specific securities relative to their "unprotected" peers in the market, the ramifications for the capital markets and the impact upon the securities lending industry that facilitates legitimate short selling. Based upon a detailed analysis of the facts, we will attempt to answer the questions raised above and make specific observations that might help inform the debate and the reader.

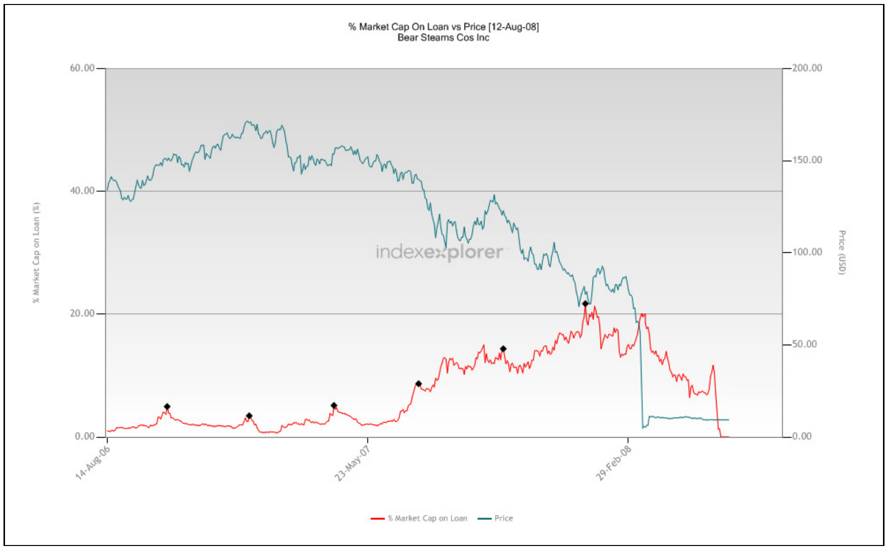
The implementation of the SEC emergency rule needs to be seen in the context of a volatile market environment entering bear market territory with the financial sector under significant duress.

The demise of Bear Stearns, as an independent business, coincided with a huge spike in trading volume earlier this year (see below), dramatic increases in securities lending volumes, increased short selling and a price collapse.



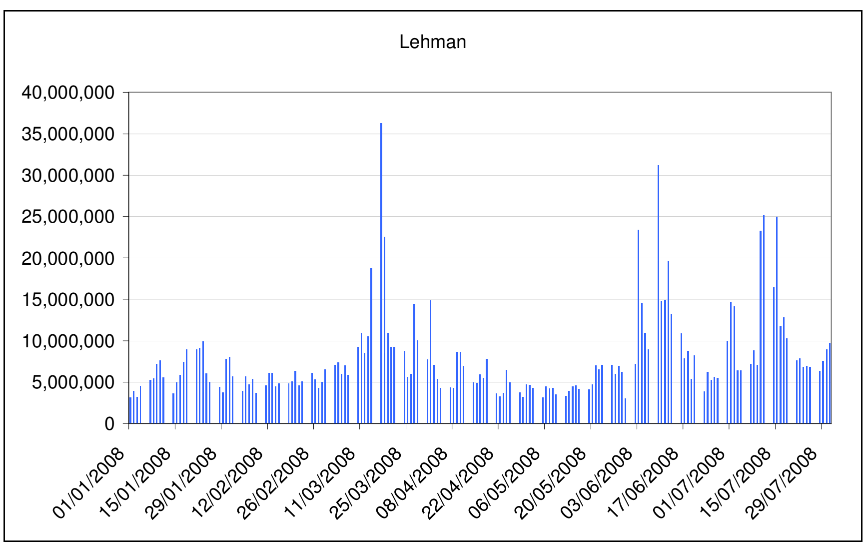
Source: - www.dataexplorers.com

There had also been a vibrant demand in the securities lending market for the securities, as demonstrated by over 20% of Bear Stearn's Market Cap being on loan in early February (see below).



Source: - www.dataexplorers.com

Towards the end of June, the SEC could see that there was a possibility of a repeat of the pattern seen in Bear Stearns in other financial securities - most notably regarding Lehman Brothers with large spikes in volume (first chart) and an extremely high percentage of its market capitalisation being on loan (second).



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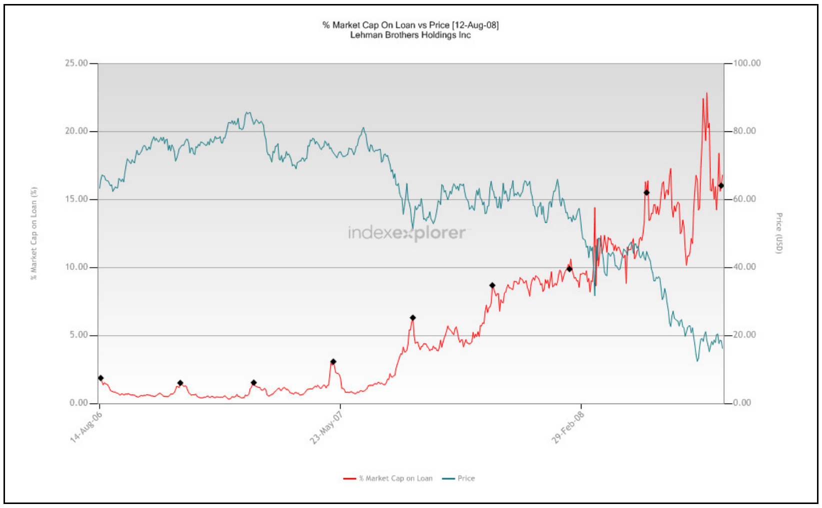
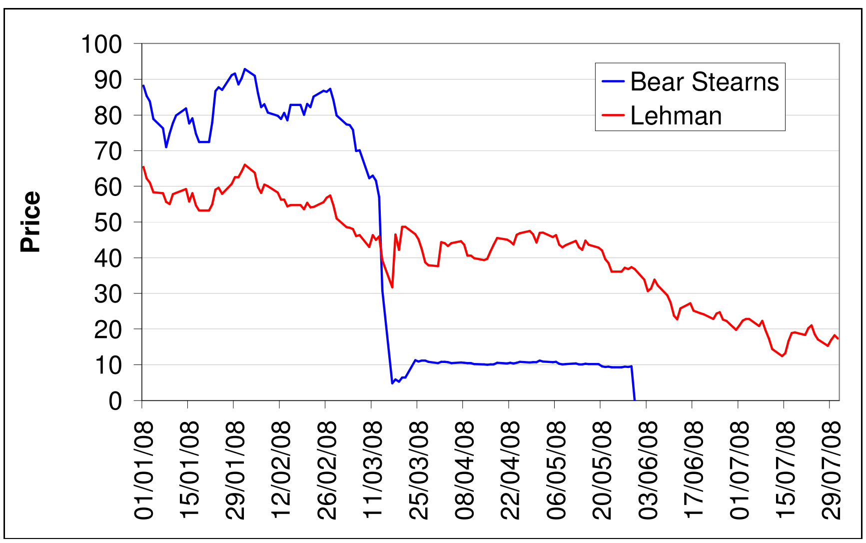


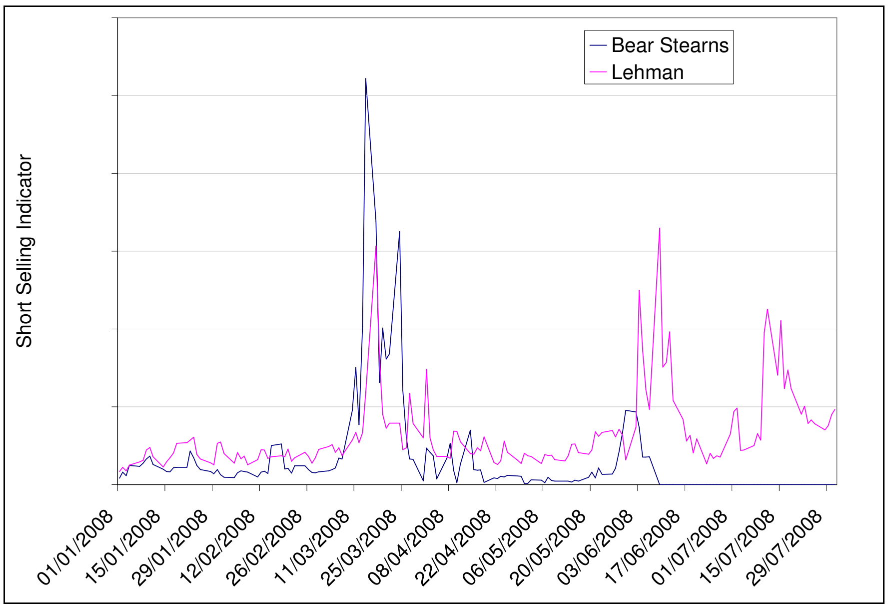
Source: - www.dataexplorers.com

The SEC was growing concerned that the surge in trading volume was being at least partly driven by rumour mongering and "naked" short selling that was undermining these financial institutions. The price performance of these securities is shown in the graph below.



Source: - www.dataexplorers.com

The graph below shows an estimate of the short selling activity in both Lehman Brothers and Bear Stearns based on an analysis of trading volumes. This proprietary measure takes into account daily lending volumes and trading volume to create a short selling sentiment indicator. Based on this analysis it is easy to see why the SEC was getting concerned. The extent to which naked shorting was responsible for the rapid price collapse is debatable. As classically defined, the 'fails to deliver' that characterize short selling failed to manifest themselves. However, it is possible that the system was being "gamed" by traders selling short naked and covering within the same trading day - therefore avoiding the need to borrow securities and also the resultant failures that provide evidence of having been short without securing a borrow. It is possible that overlaying other factors such as fails to deliver might provide a more refined naked short indicator in the future.



Source: - www.dataexplorers.com

So, it is quite straightforward to understand why the SEC felt compelled to act and we now move on to the issue of whether the action achieved the desired result.

Did the Emergency Rule have the desired impact?

The announcement of the emergency rule on 15th July coincided with a possible bottom in the bear market for US financial stocks which are trading well above July 15th levels – having enjoyed considerable volatility over recent weeks.

It would be naive to think that the emergency rule was a primary driver of share price performance during a period when the US government bailed out Fannie Mae and Freddie Mac, addressed the US mortgage crisis, when oil prices were volatile and declining and where the performance of the individual companies in the group of 19 has been "mixed", to say the very least. It would be simplistic and inaccurate to say that the surge in the percentage of market capitalisation was associated with the covering of naked shorts and that the price rise was associated with the covering or squeezing of naked short positions. This is not the case.

The surge in borrowing activity was due to the prime brokers and their clients taking an extremely cautious approach to the implementation of the emergency rule. As one prime broker said: "the cost of borrowing $100 million worth of securities pales into insignificance compared to the prospect of being on the front page of the Wall Street Journal for breaking the emergency rule. Or to put it another way - it costs only $27.00 per day to borrow $1,000,000 of a security at 1% fee." The estimated scale of the "over borrowing" for the SEC 19 peaked at around $22 billion.

The cost of borrowing the SEC 19 – all bar Lehman, Freddie and Fannie prior to the announcement of the regulations was low. The securities were what are known as general collateral securities – i.e. easy to locate and borrow. The price of borrowing the securities after the announcement rose as demand increased and it rose most dramatically the three more "special" securities.

The S&P index of all US financial stocks rose 22% from the date of the announcement until 12th August. The performance of the 19 securities subject to the rule was in line with the broader index but varies significantly and is shown in the appropriate charts. However the 19 securities share the following characteristics – significant gains in price post-announcement, with some price decline post-implementation. The New York Times observed that the price performance of the "10 largest banks and brokerage firms that were not on the SEC list rose 40 percent over the same period."[1] It is fortunate that the SEC emergency rules were not "intended to have any impact on the direction of prices," as Chairman Cox observed on 19th August – for if they had that objective; they failed.

One of the unintended consequences of the emergency rule was this surge in "over borrowing" and the cost of this to the broker dealers is very significant. Instead of borrowing securities on a net basis when they were required for settlement date, the prime brokers were borrowing gross volumes of securities when the securities were located. Only about 5-10% percent of locates actually are enacted and the over borrowing levels put additional pressure upon the already strained balance sheets of the prime brokers – many of whom are ironically on the SEC 19 list.

According to data from Data Explorers, the borrowing in the SEC 19 rose by 106% to a peak of $21.3 billion. We estimate that the change of $11bn is about half of the overall "over borrowing", which includes long box lending. This should be seen in

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[1] The New York Times 13th August 2008 – The ten securities were Wells Fargo, US Bancorp, Bank of New York Mellon, Wachovia, State Street, PNC, Charles Schwab, BB&T, Capital One and SunTrust Bank.

context of the total amount of borrowing that was taking place under the Federal Reserve Bank of New York Term Securities Lending Facility[2]. This dramatic rise in over borrowing resulted in a decline in outstanding fails to deliver any of the SEC 19 securities that was noted by Chairman Cox. This is not surprising, as all regulated broker dealers will have focused operational resources upon these names, and have excess securities available to meet any deliveries.

August 7th 2008	$24.998 billion accepted
July 31st 2008	$28.100 billion accepted
July 24th 2008	$24.998 billion accepted
July 17th 2008	$50.570 billion accepted
July 10th 2008	$21.300 billion accepted
July 3rd 2008	$26.100 billion accepted

Was the surge in borrowing on July 17th driven by the uncertainty associated with the emergency rule, or was a firm or firm's position more pressurised at that time than normal? We may never know the answer. Irrespective of the driver, it seems strange and counterproductive to be handing out cash at the Fed window to then oblige broker dealers to "waste it" collateralising over borrowed securities lending transactions as a result of the emergency rule.

Securities borrowing levels have subsequently declined from their peaks but remain at higher than pre-emergency rule levels and the borrowing from the window has returned to more normal levels. Testament to the speed is with which firms can optimise borrowing requirements, implement technical change and drive unnecessary costs out of the system - because the lesson learned is that this is the costly factor. In this circumstance the SEC unintentionally drove the cost up for the very firms that the Fed and they were trying to help in the first place.

The securities lending business is quick to embrace change and the legal framework surrounding the activity has quickly been adapted to provide borrowers with the confidence that they can comply with locate requirements without having to actually borrow (and expensively collateralise) securities. The practice of icing or putting securities on hold is longstanding, but now the securities are being segregated and held formally to the order of the locating broker to ensure that they are available should they be required. This has required significant legal compliance and IT resources, but many of the major players were able to work fast.

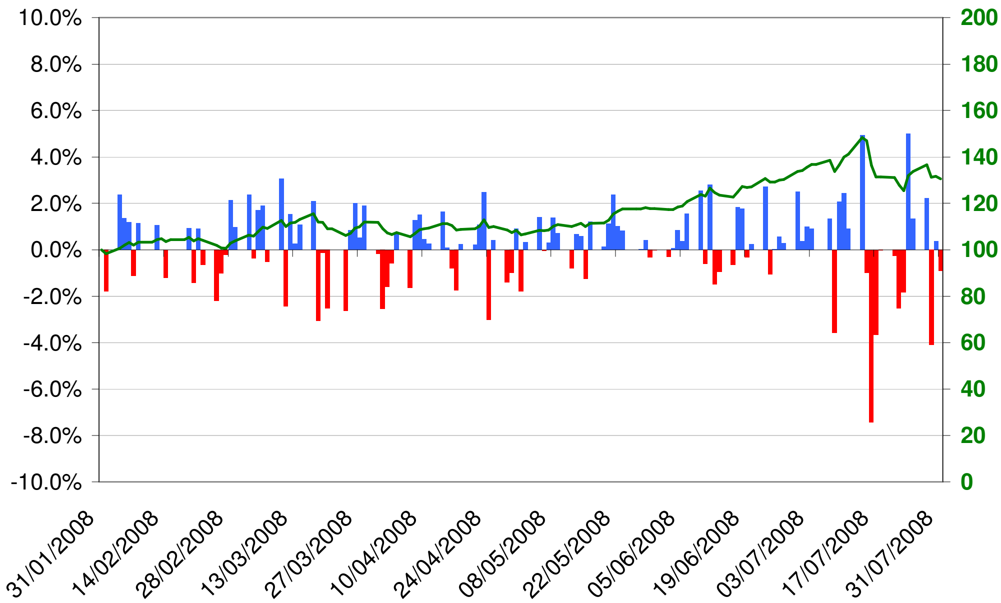
The industry could not afford to even think of the cost and balance sheet ramifications of the scale of over borrowing (and collateralisation) required if the SEC were to extend the emergency rule to the entire market. It was difficult to see how the prime brokers could take that financing pressure, and difficult to see how the Fed could meet the resultant demand for cash at the window.

[2] Source Federal Reserve Bank of New York website

One cannot necessarily conclude, based on the available data, that the emergency rule had a significant impact upon the price performance of the 19 securities in question. Their performance actually lagged that of other major financial institutions that were not subject to the rule.

Traders and Asset Managers all share the objective of making money. Their strategies and techniques vary considerably. Short selling, once the strategy of choice for the hedge fund manager, is now increasingly used by more traditional fund managers, and the impact of the emergency rule upon the growing number of legitimate short sellers is worth considering.

The graph below shows the simulated financial results for a short seller over the past 6 months, drawing from a universe of S&P 500 constituents. The bars show the daily P&L and the green line shows the cumulative value of a fund investing in a pure short selling strategy. These figures are for a fund concentrated in a limited number of stocks (in this case 25), which buys and sells on a frequent (e.g. daily) basis, and bases its positions on short interest indicators for the S&P 500 members.



Source: www.dataexplorers.com

The strategy suffered considerable losses at the time of the announcement of the SEC's emergency rule and increased volatility of returns subsequently. The strategy remains profitable but much of the return has been surrendered over recent weeks. The synthetic portfolio was not artificially constrained to the SEC 19 but it is difficult to argue that the announcement of the rule did not have a dramatic negative impact upon the returns of short sellers – maybe this is what the SEC secretly wanted?

Anecdotal evidence suggested that many legitimate short sellers with positions in the SEC 19 closed them and took profits rather than remaining exposed to increase uncertainty and doubt. The impact was not to drive out naked short positions but to artificially encourage the closing of legitimate short selling.

Conclusion

Naked shorting is a legitimate target for regulators – the SEC emergency rule was a disproportionate response to a real problem, the scale of which was not and is still not fully understood. As the Economist put it in an article entitled "Phantom Menace" "the regulator picked the wrong target."[3]

The International markets offer possible sources of a meaningful and practical solution for the US market when considering how to ensure efficient and appropriate markets. However, the solutions are much less glamorous than headline grabbing emergency rules. They lie in the strict enforcement of sound operational procedures – which already exist and are run in the US but are not enforced by the regulators. They also lie in the development of a liquid securities lending market allowing firms to borrow securities without being necessarily short beforehand – effectively what the emergency rule forced to happen and often referred to as the "relaxation of the purpose test" by practitioners experienced on the international markets.

The lack of will to enforce Regulation SHO is a major puzzle to many observers of the market – why make a rule and then not apply it? Why not make sure that buy-ins take place and close off operational problems at trade date +4 or trade +5 and not allow them to roll after trade date +13 and beyond? Such a policy would force prompt settlement and penalise those short of securities to deliver, and is highly consistent with the objective of going after naked shorting. It would also be an excellent time to close out the outstanding transactions.

Moreover, in international markets there is rarely a purpose test requirement to be met prior to the borrowing of securities. In the US markets, the purpose test remains and precludes the management of short side liquidity by the prime brokers. The removal of the purpose test in the UK has facilitated an orderly market. It has also ensured that operational or accidental naked shorting, as referred to earlier, can be covered if necessary. There is a concern that some abuse could occur if a firm attempts to corner issues, but this can successfully be dealt with as it is in the international markets. The cost of borrowing securities in high demand will also force practical economic solutions upon the market and leave politicians time to focus on whatever it is that they do best.

The strange and exotic headlines made in recent weeks indicate that it is imperative for companies whose issues are traded to begin to understand what is happening on the short side of the market better. There are many reasons to borrow securities and potentially short them. These need to be as well understood by the Investor Relations Departments of these companies as the long side of the register. Short selling is a legitimate trading practice that enables efficient price discovery and it should not be demonised by the uninformed. It must be difficult for a CEO or his or her team to admit that market or corporate fundamentals are not what they should be and so much easier to apportion blame to evil short selling hedge funds. It is time for some companies to face some difficult home truths

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[3] Economist 16th August 2008

and blame the accepted not the apportioned. The regulators owe it to the investing public to create a level playing field for all - not to encourage the chasing of phantoms. The SEC action is asymmetrical and inconsistent – they have not announced an enquiry into the companies that talk the price of their shares up in good times, or focussed upon companies with the highest short selling activity. It is understandable to try and protect the fabric of the financial system if it comes under attack but don't do it based on a mistaken premise. The market is always right. It cannot be gamed, long term, even by the regulators.

The impact of the options market upon the cash market is another area that should be focused upon as part of the solution. Options market makers hedge their positions by going long or short underlying securities positions, and these positions can sometimes be inaccurately represented in their trading blotters as a result of the long positions being lent out by their clearing broker. This becomes a particular problem should there be a surge in demand for a security, e.g. Bear Stearns. The clearing brokers have the right to lend the options market maker bull positions which they hold as collateral against their other business. The problem arises when the options market makers sell out of these positions and when the clearing agents cannot get the securities that they have lent out back in time for an efficient settlement. The result are fails to deliver, which are directly resultant from the options market activity. The failure to implement incentives and penalties associated with fails to deliver and the opportunity for options market makers to go short nakedly - albeit as a result of poor position management rather than strategically, will need closer inspection and may require legislation or some rule changes. The surge in options activity surrounding the Bear Stearns collapse and the repetition of the pattern towards the end of July was another reason that prompted SEC action and should be part of the longer term solution.

An efficient securities lending and short selling marketplace is a pre-requisite for efficient capital markets – artificially restricting or directing their operation will result in gross inefficiencies that will have significant impacts upon all facets to the capital markets and those operational in them. Accuracy not speed; economics not politics is what is called for now. Emergency rules are not the way to address these issues.

About the author

Mark Faulkner is the founder of both Spitalfields Advisors and Data Explorers Limited. After graduating from the London School of Economics, Mark has spent the majority of his career specialising in International Securities Finance. Since 1987, he has held management responsibility at L.M. (Moneybrokers) Ltd., Goldman Sachs and Lehman Brothers. He has experience as lender, borrower, conduit borrower and prime broker. During this time he has worked closely with the UK Inland Revenue and has represented firms at the Bank of England's SBLC and The London Stock Exchange's securities lending committees. In 1995 he co-founded Securities Finance International, an independent consultancy providing expert advice to the securities finance industry.

About Spitalfields Advisors Limited

Founded in 2004, Spitalfields Advisors, ("SAL") is an independent consultancy firm specialising in the provision of securities finance advice. SAL specialises in the global securities finance marketplace which is a multi trillion dollar market, generating billions of dollars of revenue per annum. SAL takes no transactional involvement in the marketplace. www.spitalfieldsadvisors.com

About Data Explorers Limited

Data Explorers Limited provides its global client base with quantitative measurement of securities lending, performance and risk. Their other services include Index Explorer, International Index Explorer, Performance Explorer, Risk Explorer and Evaluations Explorer. Data Explorers holds the most comprehensive and up-to-date data on stock lending and short-interest in the world. www.dataexplorers.com

Disclaimer

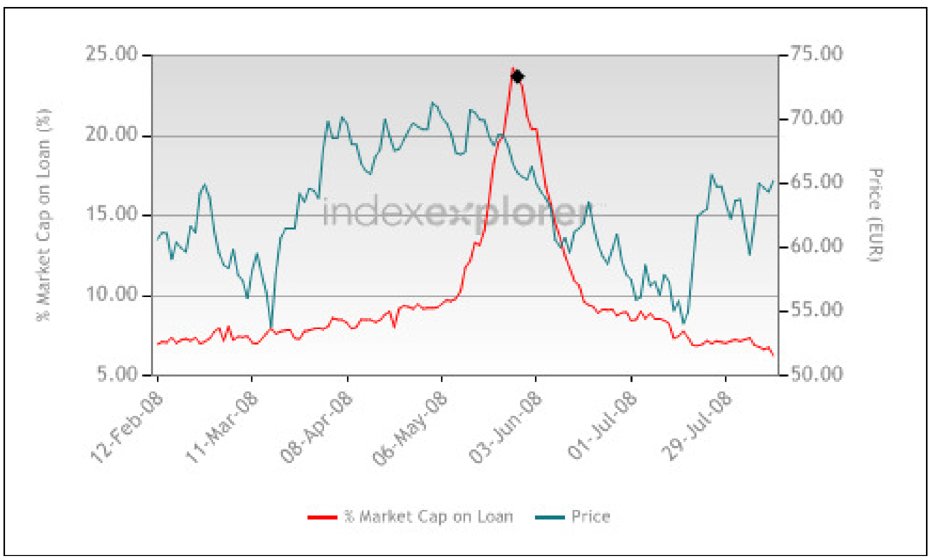
Appendix

The SEC 19 - Their Primary Listings NOT just US listed securities

As we have seen earlier, Data Explorers' short interest graphs demonstrate the percentage of each stock's market capitalization on loan (%MCOL, red line) versus the share price (green line).

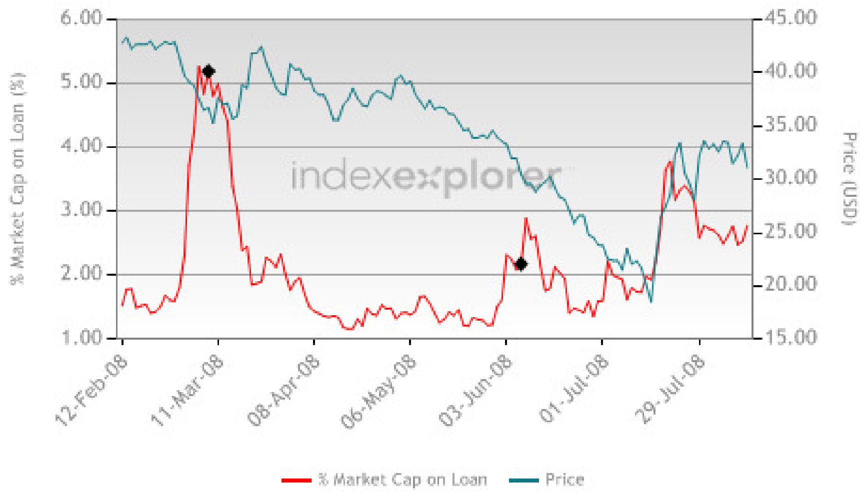
You will see quite clearly here how as the rule was implemented in mid-July and the short interest increased – so did the %MCOL. This is potentially because borrowers assumed that investors wanted to go short with this stock, and with the new SEC rule they had to have these shares in their possession – thus making inefficient market borrowing.

Bnp Paribas Sa (FR Equity (CAC)



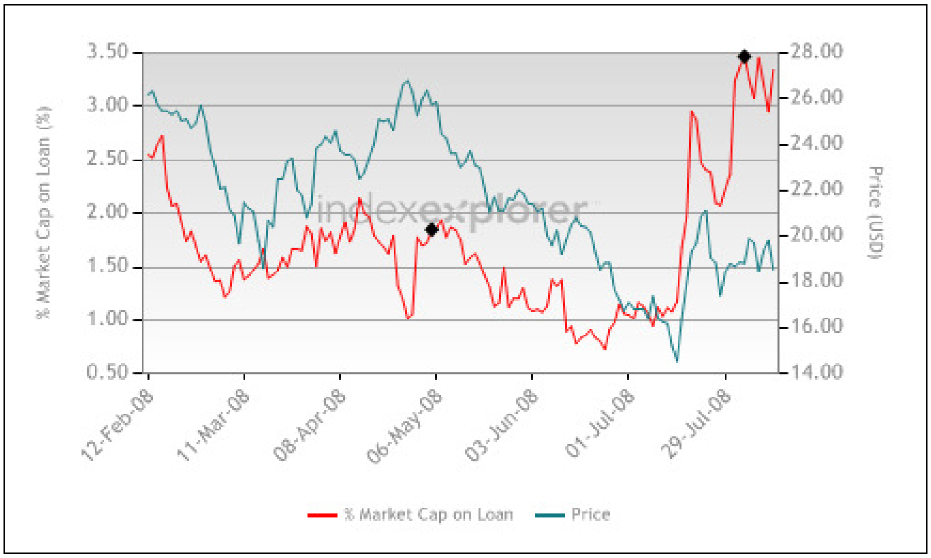
SPITALFIELDS ADVISORS

Bank of America (BAC)

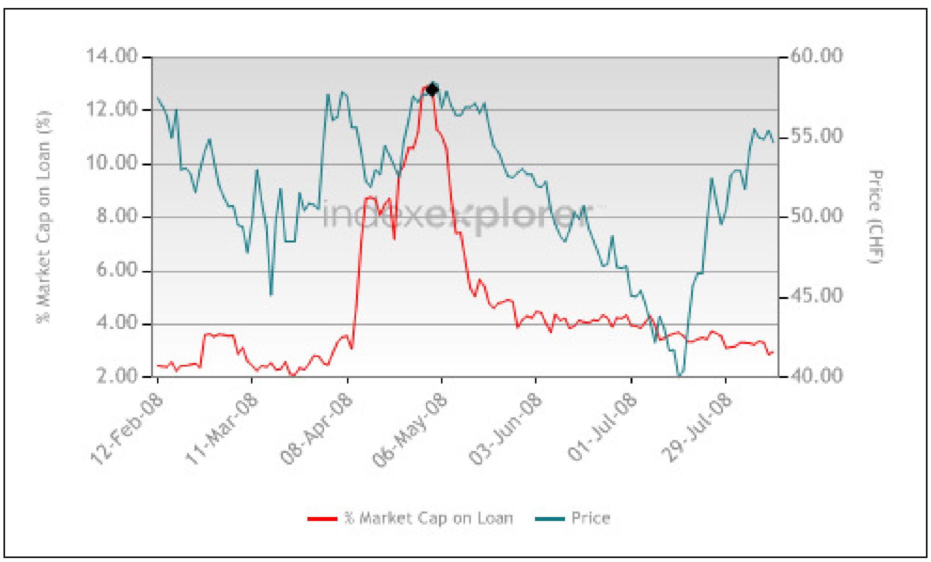


Barclays Plc (UK Equity FTSE 100)

Citigroup Inc (US Equity (S&P500)



Credit Suisse Group Ag (CH Equity (SMI))



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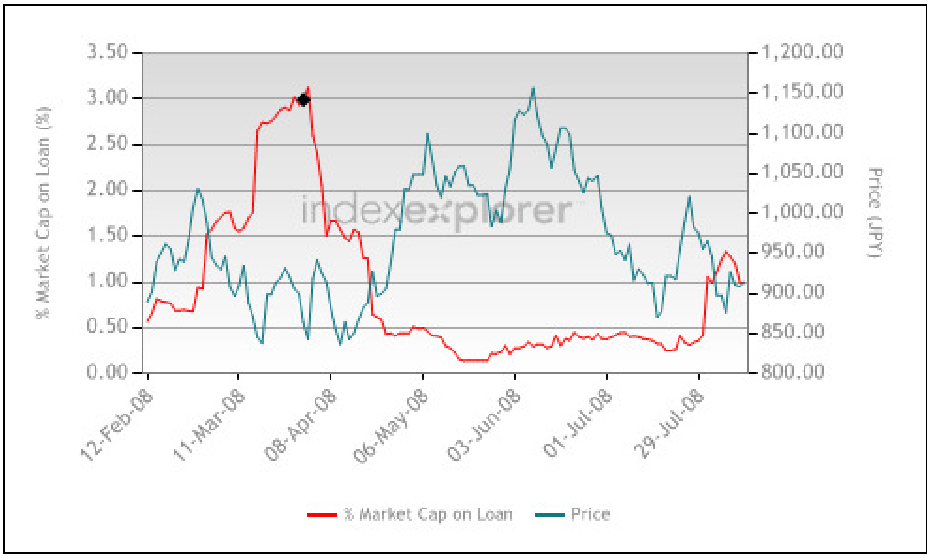
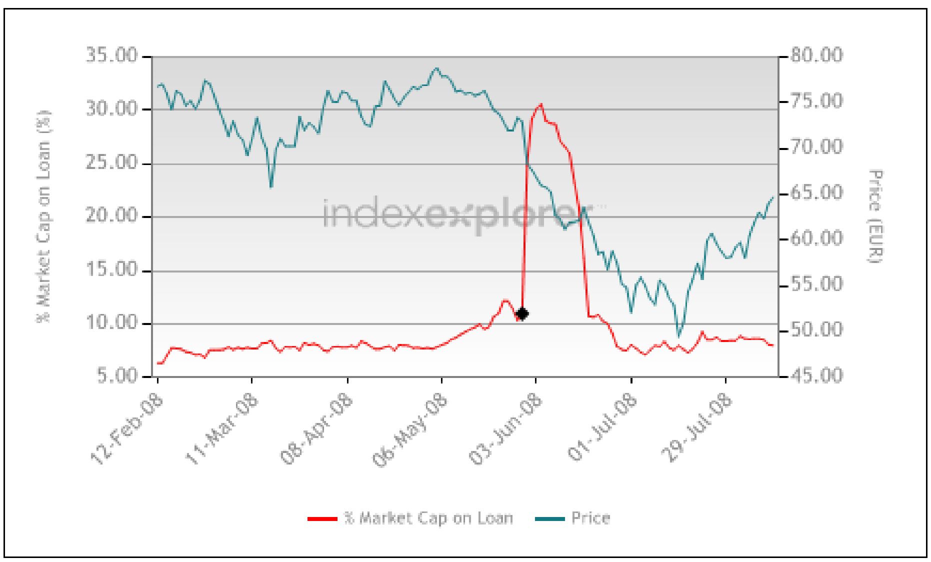
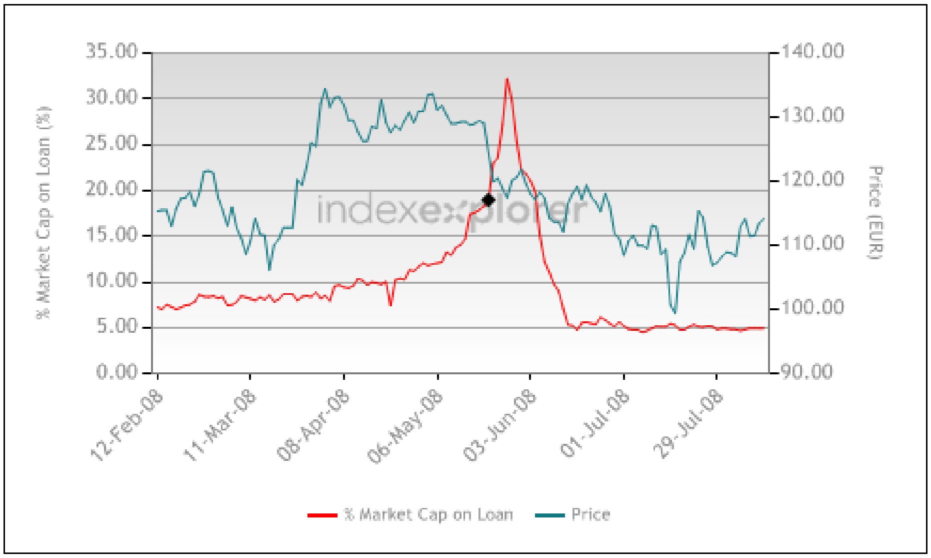
Daiwa Securities Group Inc (JP Equity (Nikkei 225))



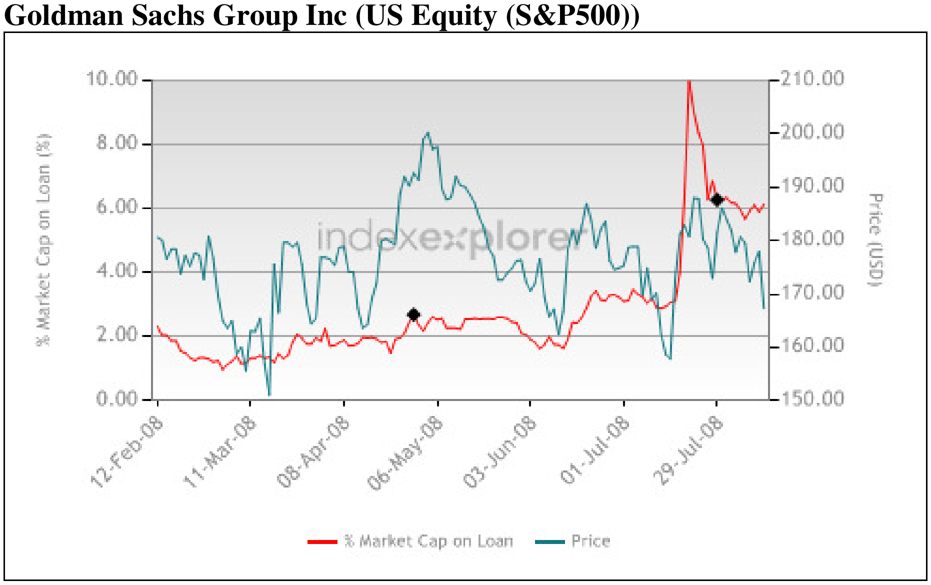
Deutsche Bank Ag (DE Equity (DAX))



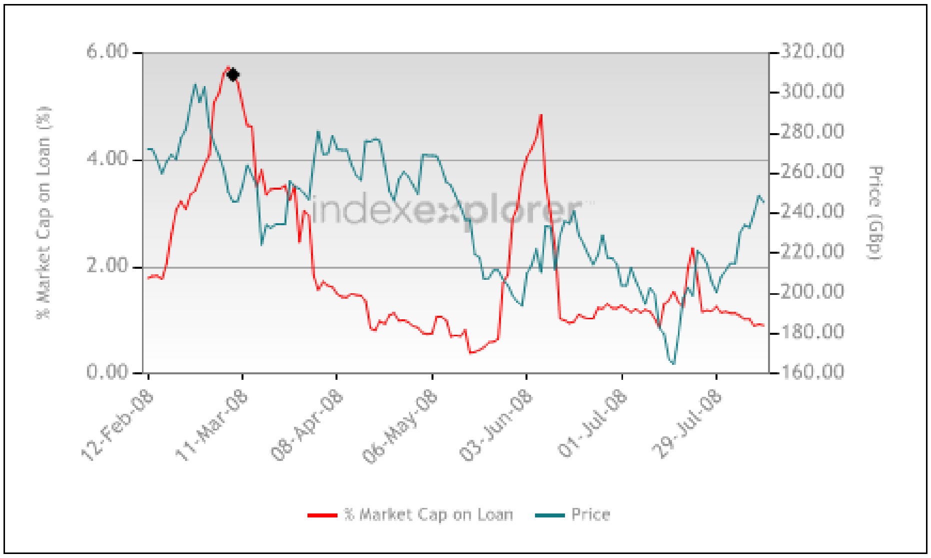
Allianz Se (DE Equity (DAX))



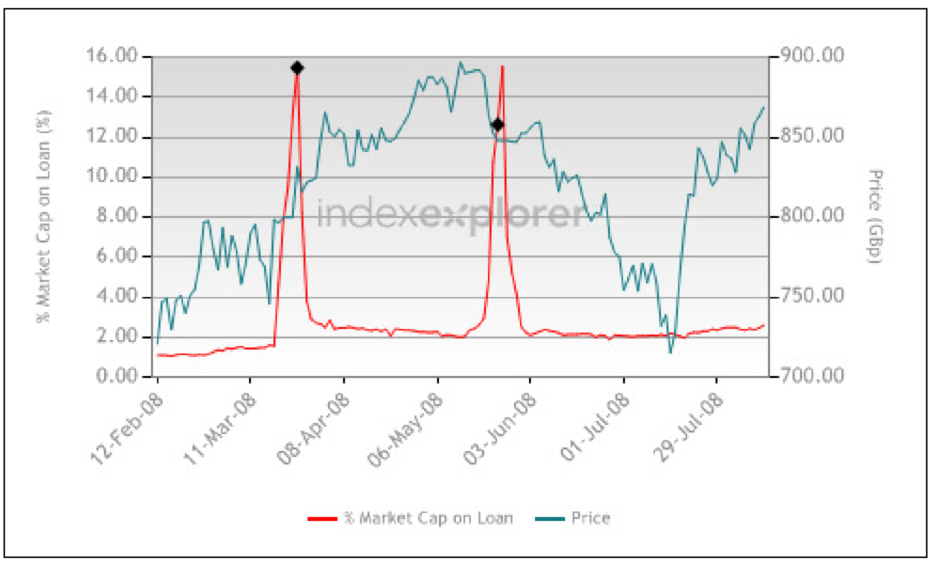
Goldman Sachs Group Inc (US Equity (S&P500))



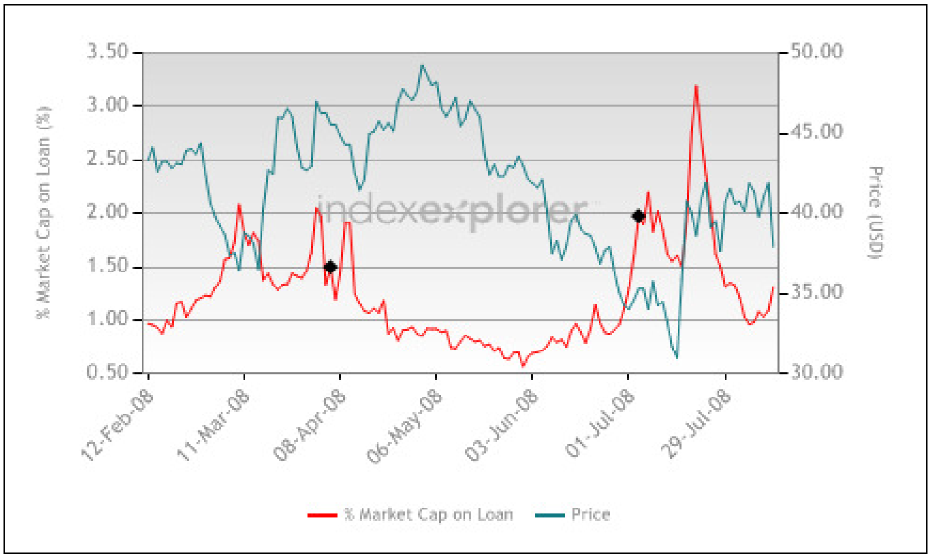
Royal Bank Of Scotland Group Plc (UK Equity FTSE 100)



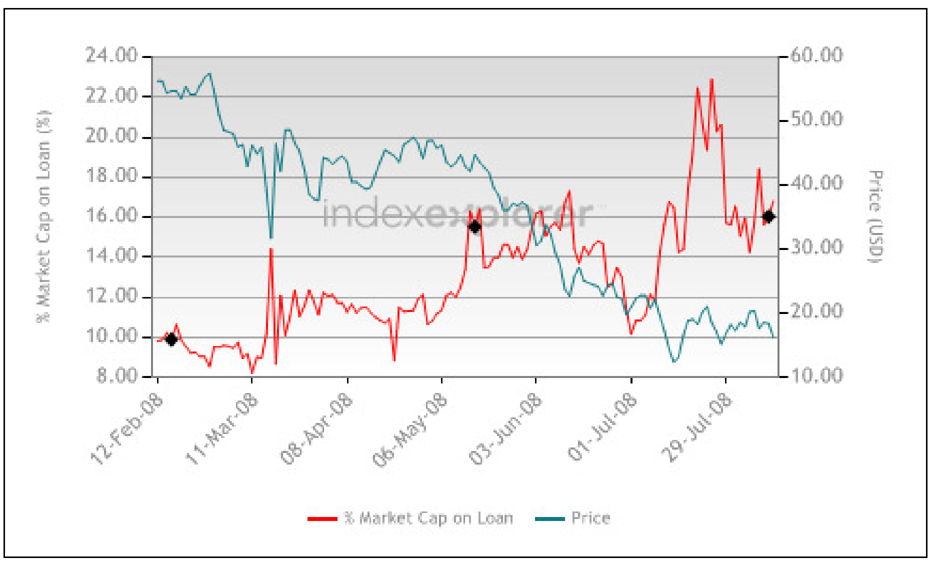
Hsbc Holdings Plc (UK Equity FTSE 100)



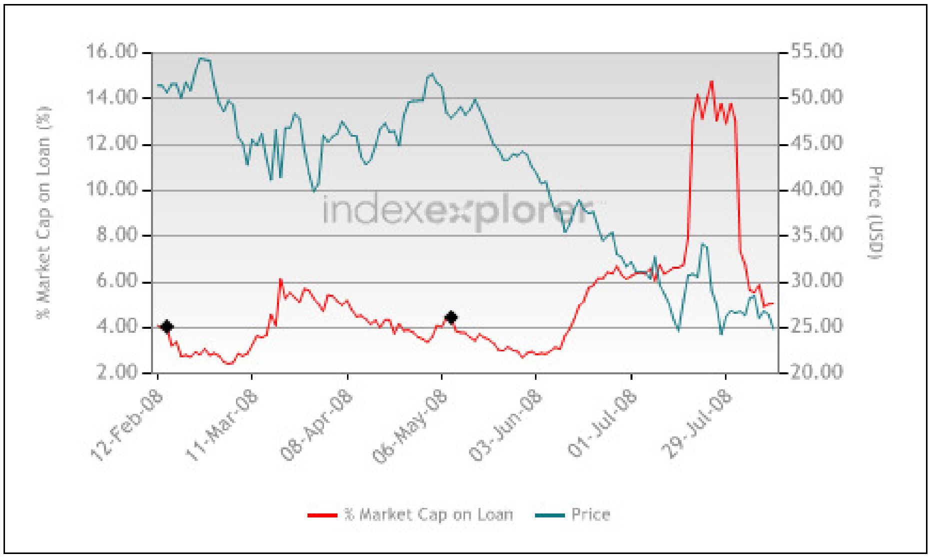
JP Morgan Chase & Co (US Equity (S&P500))



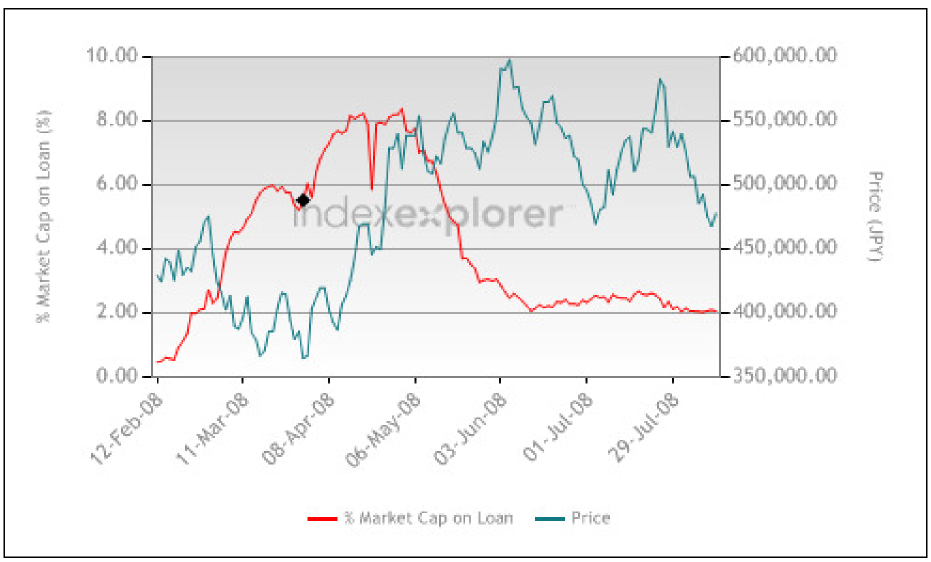
Lehman Brothers Holdings Inc (US Equity (S&P500))



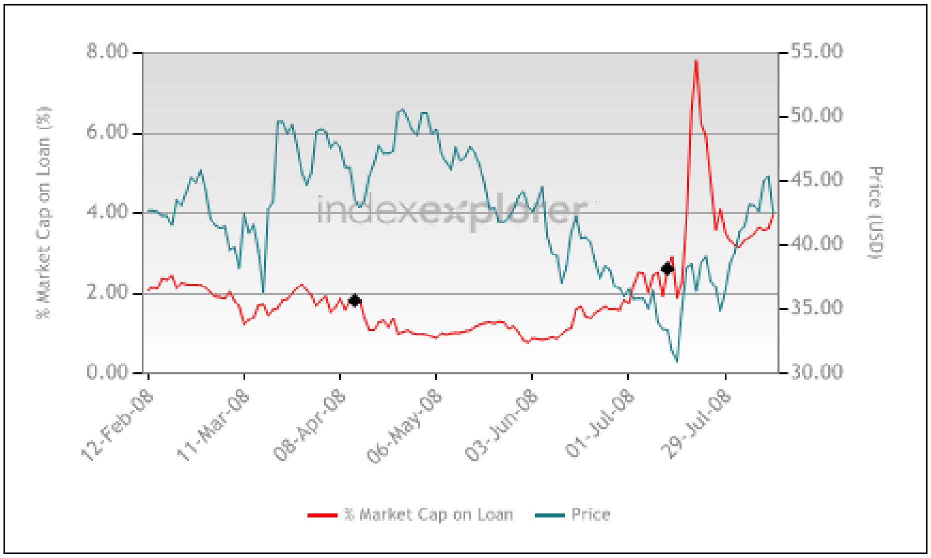
Merrill Lynch & Co Inc (US Equity (S&P500))



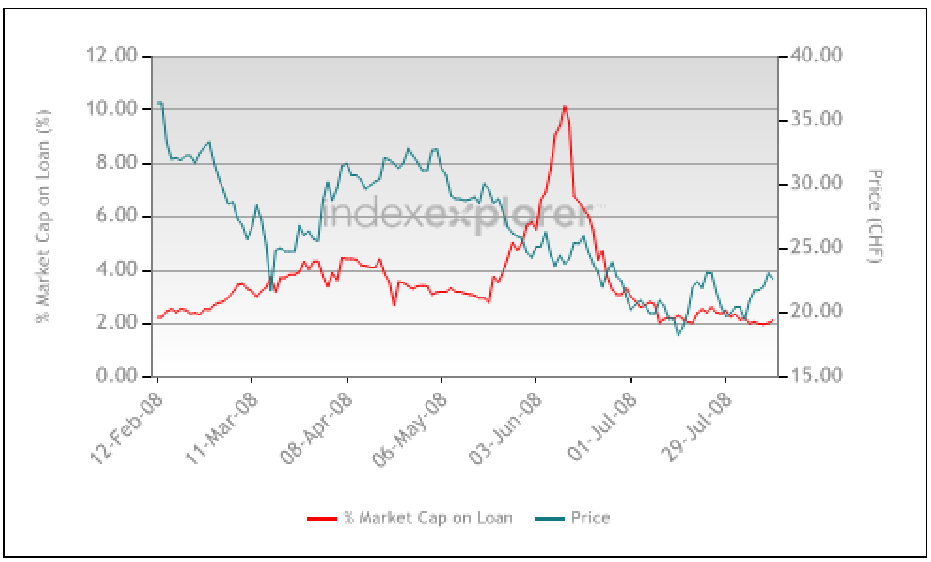
Mizuho Financial Group Inc (JP Equity (Nikkei 225))



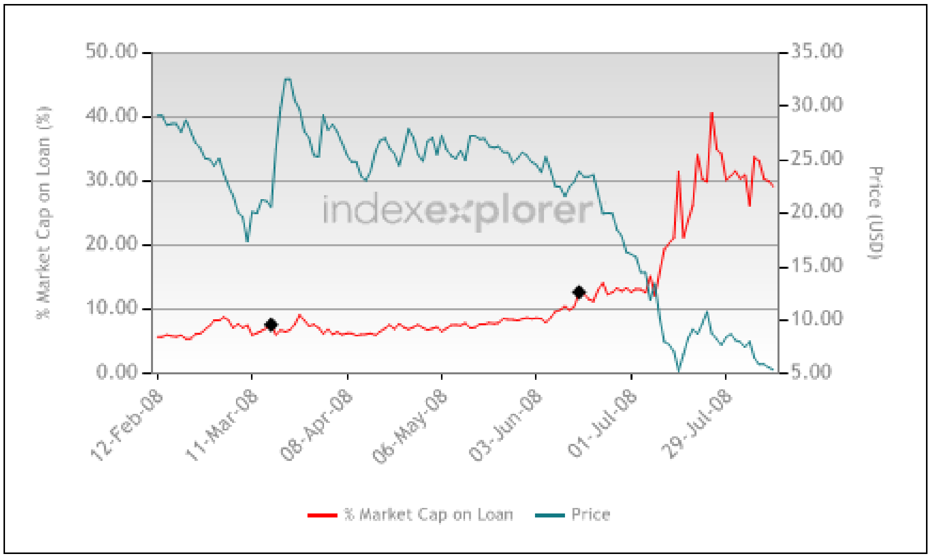
Morgan Stanley (US Equity (S&P500))



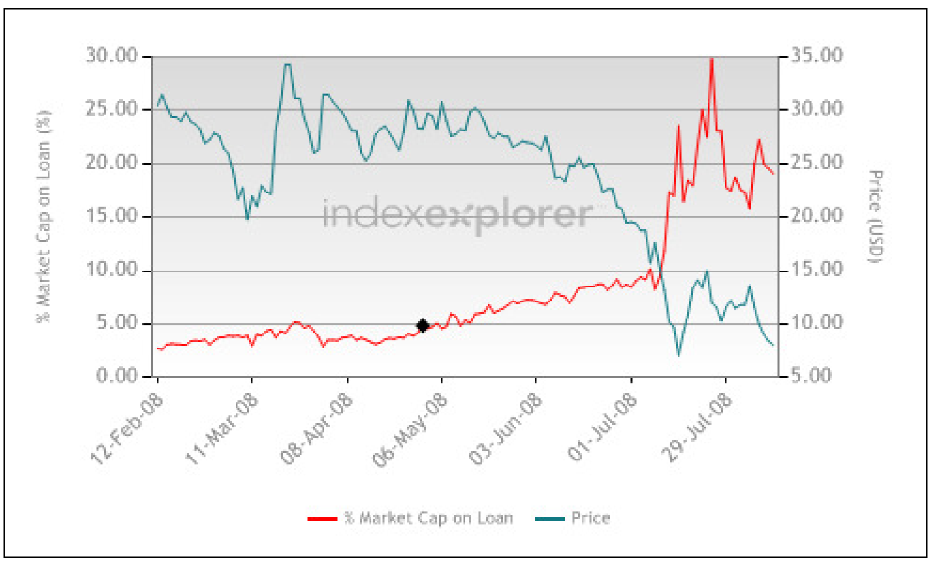
UBS Ag (CH Equity (SMI))



Freddie Mac (US Equity (S&P500)



Federal National Mortgage Association (Fannie Mae) (US Equity (S&P500))



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