Written Statement of
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Panel 1: Controls on "Naked" Short Selling: Pre-Borrow and Hard Locate Requirements

Chairman Schapiro and Commissioners, my name is Michael Mendelson. I am a Principal and portfolio manager at AQR Capital Management LLC, and one of my responsibilities includes portfolio financing. AQR Capital Management is an investment management firm that manages hedge funds, separate accounts and mutual funds. Among others, our investors include pension funds, endowments, and foundations. In employing a disciplined multi-asset, research-driven process, we often take a market-neutral approach that includes the use of short selling.

I appreciate the opportunity to appear before you to share my views on securities lending and proposals to further deter "naked" short selling (i.e. selling stock you do not own and for which you haven't received an affirmative determination that the stock is available for delivery), in particular proposals to mandate pre-borrows or institute a hard locate requirement.

Short selling is an essential activity in a market that allocates capital efficiently. Short selling improves market liquidity and lowers transaction costs. Equally important, it makes possible proper price discovery, reducing the likelihood and severity of destructive asset pricing bubbles. But, even as short selling provides helpful economic gains, "naked" short selling can deprive buyers of securities of their legitimate rights. While I believe that there is little basis for the argument that naked short selling played any role in the financial crisis of 2008 or in the failures of either Lehman Brothers Holdings or Bear Stearns Companies, I do believe that naked short selling, or at least naked short selling coupled with the subsequent inability to deliver shares to settle the transaction is a violation of the contractual obligations of the seller of a security or its clearing broker.

Regulation should seek to maximize the benefits of short selling while minimizing the problems associated with both benign failures-to-deliver and illegal manipulation. I believe that this is best accomplished by focusing narrowly on the objectives. Overly broad regulation that ensnares the vast majority of short selling activity that is both lawful and beneficial will prove costly for legitimate investors, possibly without having any effect on the problems we are trying to solve.

The effects of regulatory changes to market structure are difficult to forecast. Even more so are the effects of regulatory changes to the securities lending market, as the dynamics and interrelationships are not nearly as well understood by market participants or regulators. Because of the complex roles that securities lending and short selling play in

respect to the overall market, I believe it is especially important for the Commission to take deliberative and measured action when addressing naked short selling.

Rule 204 Is An Important Success

Rule 204 under the Securities Exchange Act of 1934, with its requirement for T+4 beginning of day buy-ins has been highly successful in reducing the number of failures-to-deliver, regardless of the reason for the failure. The Threshold Securities List is now a small fraction of its length from just a year ago, a powerful indication of Rule 204's impact on cleaning up the problem of fails of common stock.

The Rule has forced clearing brokers to be more diligent about preventing fails and monitoring affirmative determination compliance, and has encouraged short sellers to tighten their procedures. When these processes don't work, Rule 204 has a simple response – buy the stock and deliver. Rule 204 is a common sense rule; a rule that targets directly the activity we seek to minimize without creating meaningfully adverse unintended consequences.

The SEC's extensive and widely disseminated data on failures-to-deliver shows that by value, most failures-to-deliver are failures-to-deliver of exchange traded funds. Many others failures-to-deliver are of "chilled" stocks of bankrupt firms that no longer settle through DTC. Among the remaining are many stocks in transfer and fails based on custodial transfers of client positions for long sales. Failures-to-deliver of these types are both extremely difficult to prevent and, importantly, do not present the types of risks generally associated with naked short selling – the potential ability to manipulate markets.

With Rule 204 now permanently in place, I believe there remains little risk that naked short selling will be used for significant manipulative purposes in the future and tools currently available to clearing brokers are well suited for discovering and preventing what might remain of this practice. To the extent that the SEC consider additional rules to eliminate altogether the possibility of failures-to-deliver, all of the potential adverse consequences of these proposals must be weighed against what now, following the adoption of Rule 204, is the limited potential for additional protection to investors and the market.

Specifically, I believe that both the pre-borrow and hard locate proposals will impose greater costs on investors through decreased liquidity, a decline in market quality, and wider bid/ask spreads and transaction costs. Further, I believe that such proposals will provide little additional benefit to investors. As such, I do not support pre-borrow or hard locate requirements. Nevertheless, I believe that it may be possible to develop additional regulations or industry standards that enhance the ability of the SEC and intermediaries to monitor naked short selling and prevent abuses.

Pre-Borrow Requirements

With a "pre-borrow" requirement, investors are obligated to commit to take delivery of a stock prior to executing a short sale, regardless of whether or not that short sale

ultimately occurs. Today, clearing brokers are able to source stock for delivery against shorts in several ways and can manage that process efficiently so that fails are limited and investors are not unduly hindered. A pre-borrow requirement would force clearing brokers to have, on trade date, stock available for delivery and so, by increasing their inventories, probably decrease the already very low probability that there could be a fail on settlement date. It does not, however, guarantee that there will be no fail since the lender of the securities, as their owner, could recall that stock prior to the settlement of the short sale for which it was borrowed. Further, the pre-borrow requirement is entirely ineffective against fails created by short sellers who never intended to locate and deliver. A pre-borrow requirement will not change the behavior of these short sellers, be they exempted by market making or other rules or be they abusive short sellers who purposely do not locate stock as required under Rule 203 of Regulation SHO. The net result is that a pre-borrow requirement will have virtually no direct effect on abusive short selling or on failures-to-deliver.

Following the Emergency Order of July 15, 2008 mandating pre-borrow ("Order"), there was a reduction in fails for the 19 stocks covered by the Order. But, the pre-borrow requirement of the Order had no effect on the ability of an abusive short seller to continue that practice – if they weren't locating stock before the Order, then compliance with the Order's new post-locate rules was irrelevant. Instead, a likely explanation for the reduction in failures-to-deliver in those stocks is that the Order sent a clear message that there was to be regulatory scrutiny on naked short selling in those stocks. Some studies of the Order show that it caused massive over-borrowing, increased bid-ask spreads, and deteriorated market quality and market efficiency[1]. I believe that any minimal benefit of indirectly discouraging fails is outweighed by the tremendous implicit and explicit cost of a pre-borrow requirement and that the same benefit may be achieved through other, more direct means.

A pre-borrow requirement forces collateral movements from the Prime Broker to the securities lender on trade date. However, proceeds from a short sale are not available until settlement date. So, between trade date and settlement date, the Prime Broker must fund that collateral payment, most likely at an unsecured borrowing rate. Further, the Prime Broker would have to fund this requirement even for stocks that were borrowed but ultimately not sold short at all. Prime Brokers have reported to AQR Capital Management that across their client base the ratio of locates to actual short sales is well over 10 and for some, it may approach 100[2]. The result of having to set aside 10 to 100 shares of stock for every share actually needed is a new, very large, and expensive to fund cash requirement. That requirement, its level closely monitored by the Federal Reserve, would compete with other bank cash requirements in an environment where our banking and credit system is already starved for capital. Some banks would not have adequate capital to pre-borrow securities and would be forced out of the Prime Brokerage

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[1] *See* Short Selling Activity in Financial Stocks and the SEC July 15th Emergency Order, Arturo Bris, IMD, European Corporate Governance Institute and Yale International Center for Finance, August 12, 2008. *See also* letter to Elizabeth M. Murphy, Secretary, SEC, from Stuart J. Kaswell, Executive Vice President, Managing Director and General Counsel, on June 22, 2009 at p. 17 (providing comments on the impact of the SEC's emergency order mandating that securities sold short be pre-borrowed).

[2] *See also* letter to Elizabeth M. Murphy, Secretary, SEC, from Ira D. Hammerman, SIFMA Senior Managing Director and General Counsel, on September 21, 2009 at p. 5, footnote 6.

business, reducing competition and raising costs for all investors[3]. Other banks might continue to allow pre-borrows to consume their cash and balance sheet, but may be forced to reduce other activities, such as lending, in order to fund this business. Also, credit lines between banks will be consumed for no economic purpose.

Eventually, the substantial economic cost borne by the Prime Broker would be passed on to investors, increasing transaction costs, widening bid/ask spreads, reducing market volumes, and creating inefficiencies in capital allocation. The potential for adverse unintended consequences would be severe, because such a requirement would have an important influence on the structure of markets that affect all investors, many financial products, and are an important part of the funding mechanism of our banking system. This is a significant toll for all to pay for a problem that can be identified and rectified through more direct means.

Pre-borrow would result in a substantially larger quantity of stock flowing through the settlement system and for no end as the overwhelming volume of stock "located" is not, in fact, ultimately sold short by the locating investor. Fear of being unable to deliver stock will provide an incentive for Prime Brokers to hoard shares because so much of the available supply would be moving through the settlement system. Investors who actually need to borrow stock will find it more difficult and more expensive to source.

Hard Locate Requirements

Hard locate requirements can take on many forms, but generally

- In some manner segregate or identify shares to be delivered against the request to locate shares[4];
- Create substantial technical burdens and delays on all parts of the system, from investors to Prime Brokers to custodians; and
- Create a false scarcity value for locates that will increase costs for investors.

While hard locate systems do not suffer from the substantial funding problems of a pre-borrow requirement, they still force dramatic change and cost on the stock loan market, risks and costs that are not offset by important gains in compliance with short selling rules, reduction in failures-to-deliver, or, I believe, improved investor confidence.[5] Hard

[3] Prime Brokers have reported to AQR Capital Management that even under the narrow July 15, 2008 Emergency Order, some Prime Brokers told clients that they would be unable to short the Order stocks because the Prime Broker was unwilling to fund the pre-borrow

[4] One hard locate method could force Prime Brokers to specifically identify shares for a locate and decrement its remaining lending supply and, when locating stock from sources external to its own inventory, receive from the lender (say a custody bank) a statement that that lender has specifically identified shares and decremented them from its available lending supply. A more onerous form would require that lenders specifically identify shares hard located to the DTC for segregation into an account of the Prime Broker. More onerous still would be a further requirement that short sellers receive those lot identifications and verify with the DTC the validity of every short sale prior to its execution.

[5] The FSA in its February 2009 Discussion Paper, "Short Selling" writes in Section 4.12 (i) "To the extent that non-delivery remains an issue, it is probably more proportionate to address that through tightening of settlement rules rather than by introducing a blanket ban on naked shorting." Further, and relevant to the entire concern over naked short selling, in Section 4.12 (ii) "However, it is not clear to what extent naked

locate requirements will turn what is today a mostly automated, auditable process into a cumbersome, phone based, slow, and costly function.

Today's market practice for locates works on a statistical approach that has been effective for many years. Locates are provided by Prime Brokers when they believe there is very little probability that they will not be able to deliver the stock on settlement date. Hard locate systems seek to reduce to zero those already very low probability events by specifically identifying located shares. My concern with a hard locate proposal is that (1) such a proposal is unable to accomplish the goal of eliminating failures-to-deliver since even a hard locate system cannot prevent the owner of the long security position from selling, moving, or instructing its custodian to not lend those securities, thereby making those designated securities unavailable for the borrow for which they have been allocated; and (2) such a proposal would be very costly and would be throwing sand in the gears of the trading market. Furthermore, hard locate requirements may not deter naked short sellers who are not currently complying with locate rules.

Hard locate requirements generally require multiple steps of communication between a short seller, executing broker, Prime Broker, custodian, and, potentially, a clearinghouse. These layers of communication will introduce delays in the free flow of capital. I believe a hard locate requirement would impair the ability of liquidity providers to facilitate the transactions of both large and small investors, allow some investors to gain unwarranted advantage over others, and create an economic value to locates where little or none has existed to date. This last effect could lead to hoarding of stock, unnecessary new costs to burden investors, and the potential for new manipulative practices.

Hard locate requirements can take on several forms, some more onerous than others, but I believe that all forms suffer from these drawbacks.

Improving The Current System

In my view, the current Reg SHO framework with the new naked short selling antifraud rule and new Rule 204 works very well to minimize failures-to-deliver. Nevertheless, I believe more can be done to enhance compliance and enforcement of the existing requirements. I believe consideration should be given to having clearing and executing brokers conduct daily reconciliations of locates at end-of-trade-day, because this would facilitate monitoring for compliance and enforcement of the locate requirement. Such controls would directly target naked short selling activity.

In addition, I believe that in complying with Reg SHO, brokers should consider policies that require executing brokers to conduct an analysis to determine which of their clients show a pattern or practice of failing to deliver securities. Executing brokers could then prevent repeat naked short sellers from continuing this practice. Similarly, providing Prime Brokers with data from executing brokers that enables the Prime Brokers to verify that locates were obtained before the time of sale might also prove helpful. I do not, however, believe that there is any need for this data to be collected by a centralized

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shorting is used to take significant positions. Our contacts with market participants suggest that those wishing to take big positions do so on a covered basis."

organization as such a process is unnecessary and might damage investor confidence by raising confidentiality concerns.

My examination and analysis of SEC data on failures-to-deliver leads me to believe that the great majority of current fails are likely the result of acceptable market practices (e.g. securities in transfer, pending creation of ETF units, chilled securities that no longer settle through DTC, etc.) and do not present the market manipulation issues that some fear. However, it is also possible that a small portion of the data can be explained by the presence of "rolling" fails where a short seller, possibly one that is exempt from locate rules but not delivery rules, is bought in on T+4 and then promptly short sells again, still without a locate. These fails may be part of trading or market making strategies that while entirely unrelated to any practice that might erode investor confidence, nonetheless include practices that may present policy issues. I am very cautious about making any recommendation regarding this and am cognizant of the need for market making exemptions (so that market makers can perform their essential liquidity providing function), but believe further study may be warranted and the potential for abuses, monitored.

Today, it is difficult for regulators to distinguish between the sources of failures-to-deliver. Finding ways to identify trouble spots may enable the formulation of procedures to eliminate remaining short selling abuses at little cost to investors. Perhaps one tool could be to require the marking (on transaction orders) of the particular type of exemption used for all short sales executed under some exemption from the locate requirement. Standardized reports aggregating this data and linking it to fails could then be used to illuminate the sources of some failures-to-deliver.

In summary, efficient legal short selling is an important tool for investors. Protecting it while controlling abusive naked short selling should be a fundamental policy objective. The Commission already has adopted regulation that eliminates most failures-to-deliver. I believe the remainder of failures-to-deliver are primarily difficult to avoid, benign, operational fails. I oppose proposals, such as pre-borrow and hard locate that place new burdens on legitimate investors and do not address abusive naked short selling. I believe that we can, however, do a better job of identifying abuses, using both existing regulation and new compliance testing procedures.

Thank you again for the opportunity to express my views on these important market issues.