

**VIA EMAIL AND FEDERAL EXPRESS**

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Mr. Henry T.C. Hu  
Director  
Division of Risk, Strategy, and Financial Innovation  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington D.C. 20549-1090

Dear Mr. Hu:

We write you today to share our view that Section 417<sup>1</sup> of the Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) provides the SEC an outstanding opportunity to develop a sound framework for providing important short sale information to investors and other market participants. Indeed, properly done, the studies required under Section 417 of the Dodd-Frank Act should usher in a period of increased transparency and investor confidence by further reducing the opacity and suspicions of market manipulation that often surround short-sale trading.

Therefore, we respectfully offer the following recommendations for structuring the studies required under Section 417. We also hope that the SEC will look to the NYSE Euronext as a resource to assist the Commission in designing these studies and ultimately implementing their recommendations.

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<sup>1</sup> SEC. 417. COMMISSION STUDY AND REPORT ON SHORT SELLING.

(a) STUDIES.—The Division of Risk, Strategy, and Financial Innovation of the Commission shall conduct (1) a study, taking into account current scholarship, on the state of short selling on national securities exchanges and in the over-the-counter markets, with particular attention to the impact of recent rule changes and the incidence of (A) the failure to deliver shares sold short; or B) delivery of shares on the fourth day following the short sale transaction; and (2) a study of (A) the feasibility, benefits, and costs of requiring reporting publicly, in real time short sale positions of publicly listed securities, or, in the alternative, reporting such short positions in real time only to the Commission and the Financial Industry Regulatory Authority; and (B) the feasibility, benefits, and costs of conducting a voluntary pilot program in which public companies will agree to have all trades of their shares marked “short”, “market maker short”, “buy”, “buy-to-cover”, or “long”, and reported in real time through the Consolidated Tape.

(b) REPORTS.—The Commission shall submit a report to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives—(1) on the results of the study required under subsection(a)(1), including recommendations for market improvements, not later than 2 years after the date of enactment of this Act; and (2) on the results of the study required under subsection(a)(2), not later than 1 year after the date of enactment of this Act.

***I. Section 417(a)(1): State of Short-Selling On National Securities Exchanges and in the Over-The-Counter Markets – The need to monitor short selling behavior.***

To its credit, the SEC has adopted several new rules in recent years to improve the practices involved in executing, clearing and settling short sales. For example, the newly enacted Rule 204T directs that a broker dealer who fails to deliver shares sold short may not engage in additional short sales in that security without a pre-borrow or a clear and specific agreement to borrow the shares.<sup>2</sup> The SEC also recently amended Regulation SHO to enhance the delivery requirements for equities sold short and narrow the definition of *bona fide* market-making transactions that remain exempt from delivery requirements. Most recently, the SEC also instated a new version of the so-called “uptick” rule, which restricts short sales of any stock that triggers a circuit-breaker by falling in price by 10% or more within one day.<sup>3</sup>

These new SEC rules have almost certainly reduced the gross number of fails-to-deliver (“FTD’s”).<sup>4</sup> However, FTD’s continue at significant levels, especially for a discrete number of companies and exchange traded funds (“ETF’s”). Until we are certain that illegal naked short sales have been effectively eliminated, the markets will remain vulnerable to firms being potentially besieged by rumors and misinformation, followed by large-scale naked short selling<sup>5</sup>

The data show that despite the SEC’s substantial progress in regulating FTD’s, issues remain. The most-recent SEC data on FTD’s show that on August 13, 2010, outstanding FTD’s totaled 146,718,182 shares. This represents a drop of nearly 46M shares from the July 15, 2010 level of nearly 196M shares. However, there can be substantial volatility in the statistics. One company, Elsyium Internet, Inc., showed more than 197M FTD shares outstanding as of August 2, 2010, rising to more than 371M on August 4, 2010, before dropping to zero by

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<sup>2</sup> “The temporary rule imposes on the participant for its own trades and on all broker-dealers from which that participant receives trades for clearance and settlement (including introducing and executing brokers), a requirement to borrow or arrange to borrow securities prior to accepting or effecting further short sales in that security.” Amendments to Regulation SHO, Exchange Act Release No. 34-58773; 17 C.F.R. § 242. IV. B (2008).

<sup>3</sup> Amendments to Regulation SHO, Exchange Act Release No. 34-61595; 17 C.F.R. § 242 (2010).

<sup>4</sup> In addition, the SEC has proposed new “Rule 613 under Section 11A(a)(3)(B) of the Securities Exchange Act of 1934 (“Exchange Act”) that would require national securities exchanges and national securities associations (“self-regulatory organizations” or “SROs”) to act jointly in developing a national market system (“NMS”) plan to develop, implement, and maintain a consolidated order tracking system, or consolidated audit trail, with respect to the trading of NMS securities.” [Release No. 34-62174; File No. S7-11-10, see <http://www.sec.gov/rules/proposed/2010/34-62174.pdf>.] The Section 417 studies also offer an opportunity to assist in creating that audit trail.

<sup>5</sup> Robert J. Shapiro and Nam D. Pham, The Impact of a Pre-Borrow Requirement for Short Sales on Failures-to-Deliver and Market Liquidity, April 2009. <http://www.sec.gov/comments/s7-08-09/s70809-3984.pdf>.

August 12, 2010. The high concentration of failures in individual symbols raises questions about the continued prevalence of naked short selling. However, the FTD data also includes failures on long sales, which necessitates an examination of whether the high concentrations of failures are evidence of abusive short selling or naked short sales. Because the data represent total shares outstanding as of a given date, there is no direct way to determine how long the FTDs have been outstanding in a given security from the data in the bi-monthly SEC report. The SEC threshold list does indicate how long a given level of FTDs has been outstanding, but the age of particular failures is unknown. The data also include fixed income securities.

Accordingly, the SEC should continue to strictly and carefully monitor short-selling activity with the recent changes in effect. In particular, we urge the Commission to analyze aggregate short sales and FTD's in the markets, and study the behavior of short sales and FTD's in public securities and ETF's that historically have experienced the greatest short sale activity. It is important that the SEC focus on FTD activity and the reasons why such FTD's are created and resolved or not.

We further urge the SEC to establish whether all FTD activity (including FTD's generated by prime brokerages, hedge funds and broker-dealers) is included in the official FTD data that the SEC monitors and reports. In addition, it is our understanding that the data used to monitor FTD activity does not include or disclose ex-clearing or rolled transactions, the materiality of which is not known. The SEC also should consider a study tracing short sale trades to their origins in the stock loan market, in order to determine and root out inefficiencies.

## ***II. Section 417(a)(2)(A): Reporting of Real-Time Short Positions.***

We recognize that real-time reporting of the short positions of all securities, including ETF's, raises important issues. For example, there is no current capacity for real-time reporting using the form prescribed by the Dodd-Frank Act. We recommend that the SEC study how to create such a reporting system and assess its costs.

We recognize that real-time reporting may raise confidentiality issues for some professional traders and fund managers, especially concerns that reporting their short positions in real time may reveal their trading strategies. However, the Dodd-Frank Act does not require that the traders be identified, but only that the trades are reported in the aggregate.

That said, the SEC could consider two tiers of short position disclosure. The first tier could cover short-term (e.g., daily) reporting to the SEC and FINRA, so that regulators have real-time access to such data. The SEC might also exempt from this reporting requirement an appropriate de minimis amount, which does not obstruct the reporting objective of the study (e.g., activity of less than a certain percentage of market capitalization). It should also be considered whether this reporting requirement only covers equity securities, or extends to other instruments such as listed and over-the-counter derivatives.

The second tier of short position disclosure could cover a longer timeframe and would be publicly disclosed. The delay in the public reporting of short positions should alleviate concerns about revealing proprietary strategies. While achieving the correct balance between delay and transparency will be challenging, we believe it can be achieved. It remains important that investors and issuers have access to this information on a timely basis.

The reporting standards for long sales provide a reasonable guide for the proper delay in public disclosure of short positions, even though “long” reporting standards were instituted for other reasons (mainly control). While the frequency of the disclosures can be debated, the SEC should consider initiating the study using the same 90-day reporting for long positions. After a period of analysis, the study could also examine the implications of modifying the delayed timeframe. This Section 417(a)(2)(A) study of the reporting short positions should also be coordinated with the Section 417(a)(2)(B) pilot study, to evaluate some of the potential shortcomings of the pilot study, such as noise in the data, difficulty in categorizing activity, and lack of participant identity.

### ***III. Section 417(a)(2)B – A Pilot Requiring the Reporting of Trades On A Real-Time Basis through the Consolidated Tape.***

We believe that real time reporting of short selling activity would be relatively easy to carry out if the requirements covered simply long and short sales. Short sale data are generally available now, but they are suppressed from the Tape. The additional categories of “market maker short,” “buy to cover,” and “long,” require adjustments to the SIP,<sup>6</sup> unless the information for these categories is distributed through proprietary feeds. The NYSE could provide a proprietary feed for such information and likely the other market centers could as well, but this would require modification of order information by the sending firm.

The study of the impact of real time short sale reporting could also consider the risk that such reporting might exacerbate short selling. Momentum traders could possibly seek out periods of high short selling activity, increasing the risk of short selling runs.

We note that much “market-making” activity is conducted by participants that are not registered market makers, and there are multiple definitions of “market making activity” utilized in the industry. As such, we also support the announced initiatives by the SEC to revisit the definition and requirements for market makers.

We expect that investors will need time to become familiar with the new categories of data and assess their significance. For example, much short selling activity may be market making in nature and therefore may not signify a genuine short position. Marking short sale trades by

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<sup>6</sup> Currently the equities FIX specification defines Tag 54 (Side) as either 1=Buy, 2=Sell, 5=Sell Short, 6=Sell Short Exempt. There is no specific market maker flag, but the 6 could be sufficient for this. There is also no order modifier for equities “buy to cover.” This, too, would have to be added. The addition of the buy to cover field could be accommodated by adding a trade side for buy to cover or more simply adding a user defined field that would be adopted for this purpose.

actual market makers separately may help in this regard. The SEC should also consider incorporating separate marking for *bona fide* hedging activity.

We further recommend that the SEC take preventive steps to ensure that traders and brokers do not circumvent the reporting requirements. We recognize that some markets and trading platforms do not have equivalent reporting systems and corresponding restrictions and, thus, the data categories enumerated for the Section 417(a)(2)(B) pilot may be difficult to implement for such markets (e.g., OTC markets, derivatives, etc.).

We also recommend that the subsection (a)(2)A study be constructed as a pilot to analyze the costs and benefits of requiring reporting of short positions.

In designing the Section 417 (a)(2)(B) pilot program, we recommend that the SEC consider these additional issues:.

- ***Who Participates*** -- The selection criteria for the companies participating in the pilot should accurately reflect the range of publicly-traded companies, including samples of large, medium, and small cap companies, companies traded on the NYSE, AMEX, NASDAQ and over-the-counter, companies whose shares are easy-to-borrow and hard-to-borrow, companies with large numbers of current and historical FTD's and small numbers of FTD's, and companies which are and have been Regulation SHO threshold stocks and those which are not and have never been.

One option may be to list all public companies, rank them by size, and then assign every tenth company to the pilot group. That process would generate a sample covering 10% of traded stocks; the other 90% of stocks would act as controls.

- ***An Option to Opt In or Opt Out*** -- The Dodd-Frank Act suggests an opt-in structure for the pilot. We believe this will bias the sample and complicate the effectiveness and logistics of the study; as such a more objective methodology is preferable. The impact on trading behavior resulting from real time short-sale data being available to the markets is unknown. Thus, some companies may be reluctant to participate. Other companies may have a strong desire to participate in the pilot program. In addition, company opt-in may produce a non-random sample. One potential solution would be to conduct a separate sub-study of companies that want to opt-in to the program. This could be done by randomly accepting half of the opt-ins for the study and using the other half as controls. The administrators could pair off the opt-in companies by size, price, volume, industry, etc., and then randomly pick one from each pair. Similarly, a group of non-opt-ins could be randomly selected for the pilot to establish if there is any difference. However these results would still be biased versus an objective standard.
- ***Public Disclosure versus Private Reporting*** -- For research and evaluation purposes, it may be helpful if the SEC conducted two sub-pilots: The short-sale information for one sub-set of companies would be available to the general public during the pilot

period, through the Consolidated Tape; while the short-sale information for a second sub-set would be collected and released publicly with a short lag. The second sub-set would act as a control group, so the SEC and outside analysts can determine the effects on trading activity of making short sale data public on a real-time basis.

- **Reporting Requirements** -- The pilot would have to establish rules governing which party or agent will be responsible for reporting the information. These rules could be similar to current rules governing who is responsible for reporting executed trades.<sup>7</sup>
- **Uncovered Short Sales** -- Despite requirements that broker-dealers borrow or allocate shares for their short-selling clients, there are hundreds of millions of FTD's in the market on any given day. The pilot must include a mechanism that will force those reporting short sales to separately identify uncovered and covered short sales.
- **The Derivative Markets** -- The SEC should design the pilot to cover short positions in both the cash and the derivatives markets, since naked short sellers could shift from traditional shares to derivatives in order to avoid reporting their short sale activities.

#### ***IV. Conclusion.***

Again, we believe that Section 417 offers the SEC a unique opportunity to improve the public markets in a lasting way that will benefit investors and other market participants. We are available to assist and consult in any way the SEC requests in the design and/or implementation of the studies and the pilots mandated by Section 417 of the Dodd-Frank Act.

Respectfully yours,

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<sup>7</sup> See FINRA Rule 6182 that would need to be modified to include additional short sale information. [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=4387](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4387)