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http://sec.gov/rules/proposed/2011/ia-3145.pdf

This comment is directed at only one very specific issue in the lengthy release best summarized by the fact that the information requested should and could include naked short sales. Our clients believe this is a unique opportunity to obtain the type of information that has been missing from hedge funds throughout the entire subprime crisis and the entire debate about abusive short selling in spite of Reg. SHO.Short selling may contain the seeds of systemic risk and abusive short selling even more so. We believe that these entities should be asked to report on their naked short sales even if they are not deliberate. The release specifically says they are interested in leverage and collateral practices that may have systemic implications. It specifically asks whether there are other ways hedge funds could create systemic risk? the release asks about the net counterparty credit exposure of five largest trading counterparties.It could therefore be assumed that net exposure would include short selling but its more complicated then looking at net numbers. Naked short sales would completely corrupt any net analysis. As explained by Professor Branson:

As with the condemnation of "distort and short" manipulations, many market participants condemn the practice of naked short selling. In theory, if short sellers do not have to, or simply do not, deliver shares which they have purported to sell, short interest in a stock can exceed the total number of shares outstanding. On a more realistic scale, when naked short selling takes place, short interest in a stock can mount rapidly, exerting excessive downward pressure on a stock's price. Combined with the broadcast of false rumors, or an organized distort and short campaign, naked short selling can push a stock's price so far down that the price level has no connection with underlying economic realities. Buyers of such stocks, deprived of delivery, do not have the right to receive dividends or to vote shares they have purchased. In the view of nearly every market participant, naked short selling, like the spread of false rumors, is a "hit out of bounds," not considered to be within the boundaries marking a level playing field.[39]**VIRGINIA LAW & BUSINESS REVIEW VOLUME 5 FALL 2010 NUMBER 1, MORE MUSCLE BEHIND REGULATION SHO? SHORT SELLING AND THE REGULATION OF STOCK BORROWING PROGRAMS, Douglas Branson fn 14**

Short selling presents the potential for unlimited risk because unlike long sales where you can lose your entire investment, short sales present the possibility of infinite losses. George Soros explains the potential for systemic risk as follows. With *the help of this new paradigm, the poisonous nature of CDS can be demonstrated in a three-step argument. The first step is to acknowledge that being long and selling short in the stock market has an asymmetric risk/reward profile. Losing on a long position reduces one's risk exposure, while losing on a short position increases it. As a result, one can be more patient being long and wrong than being short and wrong. This asymmetry discourages short-selling.*

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Naked short selling done opportunistically avoids costs and therefore adds an incentive to the systemic risk .Numerous commenters have asked the commission to provide more visibility on naked short selling and Dodd Frank requires a study on real time reporting. But this is an added benefit opportunity where such information is complementary if not fundamental to the main purpose of the request. We have often argued that the current requirement of Reg Sho that mandates a locate but not a borrow will promote opportunistic short selling in a financial panic or terrorist attack. Relatively modest penalties that have been imposed so far would only strengthen the calculation that money is to be made and worst case scenario is the regulators will require a give back years later. Thus the proposed information gathering exercise should be especially sensitive to abusive short sales and try to obtain as much information as possible on them.

The determination of naked shorts should be decipherable through both buy-ins and shorts where no borrowing costs are incurred. Reporting entities can if they choose to distinguish inadvertent naked shorts but an explanation must be provided. If an entity cannot report then it can provide an explanation as to why it cannot do so and inability to do so should be a major concern in risk management. A recent article on the trading of GM naked CDS confirms Soros concern and suggests that without this type of information the systemic threats risk can be seriously understated.

http://online.wsj.com/article/SB10001424052748704430304576170710897188504.html?mod=WSJ_hp_LEFTWhatsNewsCollection
Lawmakers and regulators have blamed credit derivatives for exacerbating the financial crisis and helping bring down companies like American International Group </public/quotes/main.html?type=djn&symbol=AIG> Inc. and Lehman Brothers Holdings Inc. Investors who bought "naked CDS" to bet on the likelihood of default, rather than to hedge risk from other investments, are credited with worsening the liquidity crisis that gripped those financial powerhouses, prompting calls for tighter regulation of the industry.

While this subject can be debated,the need to know how large these positions are cannot be debated? As Soros concluded:
Taking these three considerations together, it's clear that AIG, Bear Stearns, Lehman Brothers and others were destroyed by bear raids in which the shorting of stocks and buying CDS mutually amplified and reinforced each other. The unlimited shorting of stocks was made possible by the abolition of the uptick rule, which would have hindered bear raids by allowing short selling only when prices were rising. The unlimited shorting of bonds was facilitated by the CDS market. The two made a lethal combination. And AIG failed to understand this.

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