

The International Association of Small Broker Dealers and Advisors

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The International Association of Small Broker-Dealers and Advisors www.iasbda.com submits the following supplement to our comments dated April 21, 2009. <http://sec.gov/comments/s7-08-09/s70809-180.pdf> . We continue to believe that this proposal has diverted the commission from the most effective remedy, a pre-borrow or hard borrow requirement and that position was confirmed by the recent GAO report. <http://levin.senate.gov/newsroom/supporting/2009/report.GAO.060309.pdf> . However recent statements by the Commission staff to the GAO require that the Commission clarify who is responsible for enforcing Reg SHO and any new uptick or circuit breaker rules. This is particularly important because any uptick rule is subject to evasion which is why most economists do not believe it can fix the problem. The use of married puts both legally and illegally is a traditional means of evading the uptick barrier. Therefore if a new tick test is imposed enforcement/surveillance responsibility must be clear. We argue hereafter that the locate requirement together with the staff's enforcement uncertainty need to be rectified before any new rules can be truly effective.

Most recently the staff told the GAO that they did not bring any cases because the self regulators were primarily responsible for the enforcement of Reg SHO due to the operational nature of the rule. Report at pp 52-53. Previously the staff told the Inspector General that since few sro referrals were made, the problem was not serious. <http://www.sec-oig.gov/Reports/AuditsInspections/2009/450.pdf> . The news media has reported that senior staff had suggested that those concerned about naked short selling were whiners or bozos. At the commission's open meeting on the proposal of Rule 10b-21 senior staff told the commission they were not aware of many complaints of rumor-mongering. By the summer of '08 they became very aware. As far back as 1991 the staff was criticized when it told Congress that it relied heavily on short sellers for information about enforcement cases. SHORT-SELLING ACTIVITY IN THE STOCK MARKET: MARKET EFFECTS AND THE NEED FOR REGULATION (PART 1) Committee Reports, 102d Congress, House Rept. 102-414, 102 H. Rpt. 414, DATE: December 6, 1991. Excerpts from this report are included below. During the 10 year period beginning in the early 90's the NASD now FINRA settled close to 80 cases involving its version of the locate rule but with minimum fines except in one case. Reg. SHO was adopted precisely because the staff believed that SRO enforcement was not adequate.

Former commissioner Campos in his comment letter on the final interim hard close rule dated March 25, 2009 noted the difficulty in bringing Reg SHO cases without a preborrow requirement. <http://sec.gov/comments/s7-30-08/s73008-108.pdf>

"Regulation SHO currently allows a short seller to execute a short sale if he has a "reasonable belief" that he will be able to locate the stock in the future. This "reasonable belief" standard allows gamesmanship and, in an enforcement action, it is very difficult to show the trader's required scienter (mental state) necessary for proving a violation of Regulation SHO A recent SEC Inspector General Report demonstrates clearly that the

Enforcement Division's attitude toward naked short selling has been to completely ignore complaints of such activity. 12 The report's findings are not surprising considering the difficulty under the current rules to show the requisite scienter. Requiring traders to pre-borrow shares, or to have a legally enforceable right to deliver the shares to be shorted prior to executing the short sale, will

(1) stop naked short selling, and (2) make enforcement easier, and thus more effective, as there will be a clear and trackable rule"

The recent GAO report noted that GAO staff did not understand how the locate requirement could be enforced or complied with absent a decrementing requirement.

Another potentially important aspect of any SEC determination regarding whether to continue to rely on the current locate and close-out requirements for mitigating manipulative short selling will be an evaluation of the effectiveness of the current locate requirement in reducing FTD and the potential for market manipulation, with a particular focus on the reliability of easy-to-borrow lists--that is, these lists must represent securities that are available for borrowing. Regulation SHO lacks specific criteria regarding what constitutes an easy-to-borrow security, but SEC found that a few firms have not followed industry best practices, which call for decrementing their inventory as locates are provided. We note that unless firms follow such best practices, it is not clear how they can ensure that they are providing locates only on their available supply of securities and limiting the potential for FTD. However, because following industry practice is voluntary, the magnitude of firms overlocating or including securities that are not easy to borrow on the list is currently unclear.

Reg SHO itself was enacted because of commission concern that the SRO's were not enforcing their rules. Yet the staff's uncertain ambivalence was noted in a 2008 interview where a very senior staffer explained:

"As to naked short selling, and more generally market manipulation generally (sic), it is an area we are focused on. We have seen fewer cases in that arena because, often times, this is not necessarily with respect to naked shorts, but shorting or market manipulation more generally, because often the components of something that might look to be manipulative are all legal trades as you point out. So it's a hard case to bring, which is not to say that it isn't something that we don't investigate, because we do. So I. hear and understand the frustration of many on the subject of short selling generally. When we hear complaints about short selling-and, frankly, it is both short and naked short, it is a combination of both-we routinely hear from companies who've come in, who worry that they're being shorted in an illegal way. We routinely take all that information in and look into it. And often times, as I think many defense counsel would be happy to tell you, when we dig in, what we find is that some of the information that has caused people to be shorting is actually true as to the company, and we may very well be confronted with two issues, one on the company and its disclosure side as well as on the trading side. But they're very difficult cases, which is not to say that we aren't focused on them and

interested in them and indeed this new focus that we have on some smaller companies and smaller issuers will wrap some of those concerns into their focus as well."

This logic of moral equivalence between the abusive short seller and the issuer has a long history and was criticized in the above referenced 1991 congressional report;

"The committees concern regarding this aspect of the SECs enforcement program is further heightened by the prepared testimony of ----- the SECs Division of Enforcement. In explaining why the SEC has not found it practical to bring enforcement cases against short sellers in most instances, he stated:

Finally, many of the complaints we receive about alleged illegal short selling come from companies and corporate officers who are themselves under investigation by the Commission or others for possible violations of the securities and other laws. When there is an obvious economic justification for short sales, it is extremely difficult to prove: . . . (ii) the material false statement/omission and fraudulent intent requirements of Rule 10b-5. This is particularly true in those situations where, for example, our investigation tends to show that at the time when short sellers were allegedly disseminating false rumors, in fact, the issuer was disseminating materially false financial statements.

This statement by Mr. ---- has the appearance of a de facto "no-action" assurance to short sellers concerning any actions they may take to disseminate false rumors about companies that are the object of SEC fraud investigations. Moreover, since the SEC does not bring formal charges against the company in many of the cases where it initiates an investigation, this statement represents a policy of ignoring possible cases of abuse by short sellers on the basis of unproven and potentially untrue suppositions about company behavior. The committee finds this policy very disturbing."

This history including the additional 1991 report excerpts below suggest that the commission needs to clearly delineate for the staff the responsibility and accountability and desire for robust enforcement. These statements do not "venture from the realm of economics to the realm of psychology" as noted in a recent letter regarding investor confidence. Investors can only read these statements in one way. Its not enough for Chairpersons to speak of aggressive enforcement, that message must be embraced and co-ordinated with the staff of both the SEC and FINRA. We suggest the following joint SEC/FINRA outline of surveillance and enforcement;

- FINRA/NYSE Regulation should have primary responsibility for surveillance and enforcement except for those cases against non bd short sellers and those cases where the subpoena of third parties is demanded.
- SEC staff should focus on insuring that the sro's do their job instead of trying to compete for cases with the sro's
- FINRA should insist that its members determine who is failing on short sales and dispel the myth that it cannot be done because of NSCC'S settlement process.
- The Commission should demand that its staff make a clear and unequivocal commitment to the enforcement of Reg SHO and any new uptick or circuit

- breaker rules and that the staff should not opine that the hard close rule has fixed everything. The commission should provide the staff with a pre-borrow rule to work with by quickly proposing a pilot pre-borrow. We understand there are arguments against a pre-borrow but we do not understand why the Commission has never sought formal comment on it which it can easily and quickly do.
- Finally as noted above sometimes the shorts are correct-but being correct can never justify abusive shorting and this point must be embraced by the commission and the staff. There is no moral equivalence when laws are broken by both sides. The rapist is not innocent because the victim also committed a crime.

Excerpts from the 1991 Congressional report.:

III. Abuse and Manipulation By Short Sellers

A. Credibility of Abuse Allegations

The subcommittee's investigation of short selling has included extensive review of the allegations of short-seller abuse offered by affected issuers and investors or reported in the press. In addition to the widespread press reports, allegations of abuse were reported by witnesses in the subcommittee's hearings, by issuers who responded to the subcommittee's questionnaire, and by other issuers and investors in numerous unsolicited off-the-record contacts with the subcommittee. The subcommittee did not, however, attempt independent verification of their accuracy through field investigation.

Because of the lack of independent investigation and verification, the committee has not made any findings that certain of these allegations were conclusively demonstrated to be true. The committee cannot, therefore, report documentation of specific incidents of abuse by short sellers.

The committee has found, however, that many of the reports of rumor-spreading abuse are entirely credible and are strongly suggestive of abuse. Moreover, the widespread nature of these reports and the high degree of similarity among them constitute a highly consistent pattern. The committee finds, therefore, that a pattern of abusive and destructive rumormongering, targeted specifically at companies in the equity securities of which some short-selling investors have established major short positions, appears to be occurring.

Other reports have alleged direct price manipulation or other trading abuses by short sellers in the trading of target companies' shares. Many of these reports have alleged that certain parties were engaging in naked short selling, presumably with the cooperation of a major broker or dealer.

None of the reports of naked short selling were supported with direct evidence, and in its evaluation of these reports the subcommittee found the circumstantial evidence offered to be inconclusive. The charges of naked short selling do raise important questions of the proper functioning of the markets, however, and the subcommittee has therefore initiated a study of clearing and settlement delays and their relationship to short selling, as reported previously.

This study has not been completed, but the evidence examined so far suggests that naked short selling or its functional equivalent does occur in large volume in some equity issues. The committee does tentatively conclude, therefore, that the reports of naked short selling offered by issuers and other investors, while lacking direct supporting evidence, may nevertheless be true in some instances.

Other allegations of direct price manipulation by short sellers have appeared to the subcommittee to lack substance. For this reason the committee has concluded that, aside from the reports of spreading false rumors and engaging in naked short selling, many of the complaints about short-seller abuse are not soundly based and may reflect a misunderstanding of the short-selling process.

b. the psychological environment

The committee's principal concern in its evaluation of short-selling issues has been broader than just whether specific abuses and violations have occurred and are being regulated. The committee is particularly concerned with whether:

a. The equity market functions fairly for investors who invest in the shares of companies that are actively sold short by other investors; and

b. Whether the equity market prices such stocks efficiently and appropriately so that these companies will continue to have access to the market for new capital on a sound and fair competitive basis.

The committee has found, in this connection, that the fairness and efficiency of the equity market for stocks that are actively targeted by short sellers suffer from serious disturbances that cannot be attributed solely to specific instances of short-seller abuse.

The pricing and trading of individual equity issues are highly dependent on subjective elements of psychology and perception among investors generally, and the committee finds that many investors and issuers have a perception that short sellers have great manipulative power over stocks. Moreover, the committee finds a widespread perception, expressed in many ways to the subcommittee, that the SEC is indifferent to the manipulative activities of the short sellers and assists them indirectly by their attitude of indifference.

The psychological environment is further affected by the fact that major short-selling investors function entirely anonymously. Under present reporting rules it cannot be known, except through a special investigation by the SEC, the exchanges, or the NASD, who is holding the major short positions in a particular stock.

The committee finds a strong undercurrent of disillusionment with the public equity markets and with the SEC in the viewpoints expressed by many investors and issuers whose shares are targeted by short sellers. Among these investors and issuers there appears to be a sense of being victimized by powerful but unknown abusers who do their will without restraint from any regulators. If these were isolated views, they might not be

significant, but the committee finds them sufficiently prevalent to constitute a troubling pattern.

In some instances, as reported previously, the targets of short selling appear to have drawn conclusions about the manipulative power of short sellers without a solid factual basis, but this tendency of many investors to draw such unfounded conclusions is the fundamental reason for concern about the psychological climate.

The fact is that some short-selling partnerships possess very substantial financial resources and a capacity, financially speaking, to influence heavily or even dominate the trading activity in a small capitalization issue of stock over an extended period of time. When this general fact is combined in the minds of company executives and shareholders with the information that some unknown but presumably powerful party or parties is or are actively short selling a particular stock and when these executives and shareholders also share a conviction that the SEC ignores abusive practices by the short sellers and does not ensure a fair market it is readily understandable that these executives and shareholders of the affected issuer may reach exaggerated and ill-founded conclusions about the short-selling "threat." When such exaggerated reactions to active short selling become frequent and persistent, as the committee believes they have in many stock issues, then pricing efficiency and market fairness suffer.

Moreover, the impairment of pricing efficiency affects not just the immediate targets of short sellers but the entire class of firms, many of them small but some large as well, that are viewed in the investing community as potentially vulnerable to short-seller abuse. Given the perceived power of anonymous short sellers to manipulate the market, it is only ordinary prudence to many investors to avoid such issues altogether, which in turn unjustifiably depresses the pricing of such issues relative to others perceived as less vulnerable.

This analysis of pricing inefficiency would not be valid if short sellers do in fact possess the great capacity to manipulate prices and hurt companies that is widely attributed to them. That is, if these investor evaluations of the short-selling threat are soundly based and relatively accurate on average (i.e., statistically unbiased), then the resulting effects on pricing could be compatible with efficient market functioning. The foundation of this analysis of probable pricing inefficiency is that, on the contrary, the psychological environment surrounding short selling has led investors to systematically overestimate the manipulative power of short sellers. Although there appear to have been some cases of serious abuse with a potential for significant price distortions on individual issues, the committee does not believe, as a general matter, that short sellers possess the extraordinary manipulative power that is widely attributed to them.

This is precisely the environment in which improved public information is clearly needed. While not necessarily providing a complete solution, better public information is the natural first remedy for such difficulties. By injecting factual clarity, it reduces the scope for fear based on imaginative speculations and unfounded assumptions. The issue of improved public information is discussed in Sections IV and V below.

C. The American Stock Exchange Surveillance Report

In 1987 the American Stock Exchange received complaints from three companies that holders of short positions were engaged in downside manipulation of the company's stock. Each company reported that it was the target of malicious negative rumors which, it felt, were being spread by the short sellers as part of a scheme to depress the price of its stock. In addition, many negative press stories had appeared about these companies, notably in Barrons.

The American Exchanges Surveillance Department conducted investigations into the short selling of each company's stock. It compiled detailed trading data on these companies' stocks for certain study periods that ranged from 3 to 12 weeks and attempted to determine whether any of the short sellers had engaged in price manipulation in their trading during the study periods.

The trading data compiled in the investigation and the Exchange's findings were reported to the SEC. In each case, the Exchange concluded that none of the information it gathered revealed evidence of manipulation by short sellers. However, it stated that it could not determine whether certain principal short sellers had acted in concert. Moreover, since most of the principal short sellers were not members of the Exchange and therefore not subject to the Exchange's jurisdiction, it stated that the Exchange could not do a thorough investigation of the short-sellers' activities. It submitted the report to the SEC with a recommendation that the SEC should further investigate the activities of the short sellers to determine whether the short sellers had acted in concert to depress the stock prices.

The Exchange also made a limited attempt to evaluate the companies' claims of false rumors, but this work did not represent a thorough investigation. In its report the Exchange concluded that the charges of false rumors were a subject for the SEC to deal with. In particular, it recommended that the SEC should determine whether there had been any improper contact between the short sellers and the press.

The SEC did some additional investigation after it received the surveillance report. This included contacting the companies and the stock analysts that followed the companies, as well as searching various databases for negative articles or other information about the companies. Although it found negative articles from its database searches, the SEC said it did not find any articles which contained materially false information about the companies. In describing its response to the American Exchange's recommendation for further investigation, the SEC stated to the subcommittee that it found no indication of illegal activity by the short sellers in these cases and, moreover, that the SEC had brought action against one of the companies involved for improper accounting methods.

The subcommittee found, on close study of the Exchange's surveillance report, that the report contained both statistical discrepancies and unexplained information gaps. When questioned, the Exchange attributed the statistical discrepancies to human error but was unable to explain why certain information requested from one broker was never received. More importantly, the study periods selected by the Exchange for the three stocks did not correspond to the months when the reported short interest for these stocks was highest, or

to the build-up of the short interest figures to their highest levels. Moreover, in the case of two stocks, high volume trading days occurred in the week immediately prior or subsequent to the study periods but were excluded from the study periods.

Finally, the Exchanges evaluation of the extensive trading data that was assembled lacked focus. It was never clearly stated what pattern they were looking for or what pattern would have raised concerns about manipulation. For this reason and because of the inadequacies cited above, the committee, while acknowledging the extensive effort of the Exchange, questions the effectiveness of its surveillance examination.

Moreover, the inadequacies found by the subcommittee should have been evident to the SEC but apparently were never detected. The committee finds, therefore, that the SECs response and followup to the American Exchange surveillance report were superficial and did not represent a serious effort to investigate the company charges of manipulation by short sellers.

D. The Role of the SEC

The Securities and Exchange Commission is responsible for enforcing the antifraud and antimanipulation provisions of the securities laws, and agency witnesses testified in the subcommittees hearings that the agency performs this responsibility vigorously when evidence of illegal behavior by short sellers is brought to their attention. In support of this the agency testimony cited certain enforcement cases brought by the Commission where the behavior of short sellers was challenged.

Other witnesses questioned the adequacy of the SECs efforts to control short-seller abuses, however. Moreover, several company officials have told privately of bringing complaints of short-seller abuse to the SEC without any apparent SEC action resulting. Some company officials even reported to the subcommittee that, after they brought their complaints to the SEC, the SEC turned around and investigated their own companies groundlessly for suspected accounting fraud, public disclosure violations, or other matters, without ever bringing formal charges.

The SEC has never, as far as the committee is aware, brought an enforcement case or even sought seriously to investigate a case in which the central allegation of abuse was the malicious dissemination of false or unverifiable negative reports about a public company, its officers, its products, or other matters that, if true or believed by investors, would be likely to influence negatively the trading price of the companys stock.

For this reason, the committee finds substantial basis for concern that the SECs policing of the fairness of the markets in this respect may not be adequate.

The committees concern regarding this aspect of the SECs enforcement program is further heightened by the prepared testimony of ----- the SECs Division of Enforcement. In explaining why the SEC has not found it practical to bring enforcement cases against short sellers in most instances, he stated:

Finally, many of the complaints we receive about alleged illegal short selling come from companies and corporate officers who are themselves under investigation by the Commission or others for possible violations of the securities and other laws. When there is an obvious economic justification for short sales, it is extremely difficult to prove: . . . (ii) the material false statement/omission and fraudulent intent requirements of Rule 10b-5. This is particularly true in those situations where, for example, our investigation tends to show that at the time when short sellers were allegedly disseminating false rumors, in fact, the issuer was disseminating materially false financial statements.

This statement by Mr. ---- has the appearance of a de facto "no-action" assurance to short sellers concerning any actions they may take to disseminate false rumors about companies that are the object of SEC fraud investigations. Moreover, since the SEC does not bring formal charges against the company in many of the cases where it initiates an investigation, this statement represents a policy of ignoring possible cases of abuse by short sellers on the basis of unproven and potentially untrue suppositions about company behavior. The committee finds this policy very disturbing.

Finally, the committee finds that there has been an uncomfortably close direct working relationship between certain unknown short sellers and the SEC enforcement staff. Mr. --- -- acknowledged in the subcommittee hearing that the SEC staff "listen" when short sellers make allegations that a company is doing something wrong, because the short-sellers information is often accurate. Short sellers, in other words, frequently provide useful enforcement tips to the SEC staff.

That the SEC staff does frequently act on the tips provided by short sellers may also be inferred from a statistical survey the subcommittee staff conducted, with SEC cooperation, of SEC investigations of NASDAQ companies for accounting fraud or other fraudulent public disclosures during the period March 1989 through March 1990. During this period 24 percent of the formal were investigations targeted at companies in which the reported short interest in the company stock immediately prior to the opening of the investigation was at least 5 percent of the public float in that company's stock. That is, substantial percentages of all SEC investigations of NASDAQ companies during this period were investigations of short-seller targets.

The subcommittee does not find anything inherently improper in this pattern of enforcement investigations by the SEC. This pattern does, nevertheless, raise a troubling question. The question is whether the SEC's selection of investigation targets is biased in a manner that provides unwarranted assistance to the short sellers

The knowledge in the market that a company is the object of an SEC investigation for possible fraud is generally expected to disappoint or alarm investors and to directly cause a decline in the company's stock price. The opening of such SEC investigations after short sellers have established substantial short positions in the target company's securities is therefore very beneficial to the short sellers. For this reason the SEC needs to exercise extreme caution in opening investigations of short-seller target companies, especially on

the basis of tips from the short sellers, in order to guard against any appearance of bias favoring the short sellers.

Regardless of the appropriateness, from an enforcement perspective, of the investigations opened regarding possible fraud by short-seller target companies, the de facto working relationship between short sellers and the SEC enforcement staff has the effect of providing bounties to the short sellers for their enforcement tips when the enforcement investigations become known in the market. In this context, the committee finds it highly improper that the SEC staff should also exempt from any enforcement scrutiny the behavior of the short sellers whose tips they determine to act on, as Mr. testified investigations opened involving NASDAQ companies, and 17 percent of the informal investigations opened involving NASDAQ companies,.

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