LPI

LIFE PARTNERS INC
A LIFE SETTLEMENT PROVIDER

RECEIVED
ES 130650
2009 JUN -4 AM 10: 13

CHAIRMAN'S
CORRESPONDENCE UNIT

May 28, 2009

RECEIVED
AUG 04 2009
OFFICE OF THE SECRETA

Chairwoman Mary L. Schapiro
SEC Headquarters
100 F Street, NE
Washington, DC 20549

CC: Madame Speaker Nancy Pelosi

Dear Madame Chairwoman:

I am writing to you in order to express my company's views on the proposed short selling rule changes that the Commission is currently considering.

We would like to recommend that the Commission puts rules in place that will require short sellers to pre-borrow stock. We would also like to see a hard delivery requirement, where securities must be delivered by T+3, or the broker would be required to do a forced buy in for its trading clients.

In addition to the above, we would like to see these rules enforced vigorously, with stiff penalties for violators - such that the rules will actually force behavioral changes on the part of market participants.

We are of the opinion that the discussions regarding the reinstatement of uptick rules are a red herring. Reinstating the uptick rule would in no way end a bad actor's ability to naked short a stock and fail to deliver it. Yet, for those who are advocating this rule, it has the appearance of solving the problem without actually solving anything.

Others have declared that manipulative/naked short selling problems have been solved, so we can now collectively move on to other issues (e.g., Floyd Norris in his recent *New York Times* article). This could not be further from the truth. Our company's stock shows the lie of this premature declaration of victory along with Lehman Brothers and many other companies.

I've enclosed with this letter a copy of a study performed by Robert J. Shapiro and Nam D. Pham that empirically demonstrates that pre-borrow requirements will not harm the market's liquidity, as well as evidence that shows that similar requirements in other countries' markets have had an overall beneficial effect on prices.

This paper asserts, and provides exhaustive data that proves that a pre-borrow requirement will not harm the markets, as well as showing that the current rules in force are not truly curtailing the failure-to-deliver problem:

204 Woodhew Drive Waco, Texas 76712 800 368 5569 www.lifepartnersinc.com

- Naked short selling and the resultant failures-to-deliver contributed to the unmanaged and widely disruptive collapse of Bear Stearns and Lehman Brothers.
- Current regulation has not stemmed failures-to-deliver in meaningful ways.
- Naked short sales increased volatility in stock returns without producing more efficient prices.
- Strict regulation of short sales in financial firms, including a pre-borrow rule, did not impair market liquidity.
- A pre-borrow requirement for short sales would not damage market liquidity.
- Application of a pre-borrow requirement would not entail additional costs for short sellers.
- New regulation of short sales, including a pre-borrow requirement, should be able to effectively control naked short sales and failures-to-deliver at no appreciable cost to liquidity or efficiency.

We concur with the findings of this paper and have included it here as empirical support for the short selling rule changes we are requesting to be made by the SEC.

Background

I am the Chairman and CEO of Life Partners, Inc., a life settlement provider based in Waco, TX (Nasdaq GS: LPHI). I founded the company 18 years ago, and have worked tirelessly to provide an excellent product to our clients, as well as deliver value to our shareholders. We have experienced tremendous growth (20%+ per annum) over the last couple of years and this growth pattern continues due to our hard work and commitment to our clients.

However, within the last two years, our company's stock has been manipulatively short sold, as well as naked short sold. We have been on and off the Reg Sho list at various points in time and are currently off it, but it is my firm belief that there are many FTDs in the "ex-clearing" environment that continue to depress our stock. We are allocating significant resources to find out who is committing this manipulative short selling and putting a stop to it.

Along these lines, I had a conversation recently with the head of a well-regarded investment bank. He sits on the board of SIFMA and owns portfolio companies, the stock of which are being manipulatively short sold. In our discussion, he referred to the SEC as a "joke" and stated that we should not count on any enforcement action or help from the SEC regarding the manipulation of our stock.

What a sad commentary -- to hear the head of an investment bank make that kind of declarative statement about the very organization that is charged with maintaining fair and equitable capital markets. I believe that if the SEC were to put in place the pre-borrow requirement along with hard delivery requirements, it would go a long way toward restoring the public's confidence in the capital markets.

As the situation stands right now, a small and interested few (hedge funds and their prime brokers) have figured out how to pick the pockets of a naïve public, which remains under the impression that our nation's capital markets are fair, regulated and safe for our retirement money.

I urge you, now that you are newly in charge of the SEC that you clean up the manipulative and naked short selling activities and make our markets a fair and level playing field both for our company's investors in particular, and for the investing American public in general.

Erosion of the Rule of Law, Private Property Rights and the Destruction of the American Middle Class

In our great nation, there have been two keys to our economic success, that I believe have caused us to dwarf all other nations on the planet in terms of economic power:

- Equal protection under the law

- Private property rights

When either one of these two basic American rights are violated, corruption and poverty are the consequences we face.

I believe, in the case of the naked short selling epidemic that has plagued our markets that both rule of law and property rights are being violated every time there is a failure to deliver. Years and years of savings have been wiped out through the destruction of Bear Stearns, Lehman Brothers and the general decline of the markets over the pas 18-24 months, with many failures to deliver along the way.

As my company is in the business of investing clients' funds as agent, I frequently hear stories of retirees going back to work, or stories of individuals who now have to work 10 more years due to losing so much of the savings in the stock market decline.

As noted in the research paper I have included with this letter, there have been 5,000 complaints of naked short selling brought to the SEC. A little over 100 have been investigated, and there has not been a single successful prosecution.

In my observation, this is a complete lack of rule of law in our securities markets, as well as a violation of property rights. As far back as the Act of 1934, timely delivery of shares has been a key to maintaining orderly and fair markets. To allow fails to persist at all, in any circumstance, is to allow criminal behavior to continue unabated. Thusly, the shareholders with "IOUs" in their accounts are not receiving any protection from the law, and without even knowing it, they have been impoverished. In effect, counterfeiting is allowed to persist in our markets without any meaningful legal action taken against the perpetrators.

I have also observed the selective application of justice by the SEC. One of the most infamous cases, as I'm sure you are aware, is the firing of Gary Aguirre by the SEC when he was pursuing an enforcement action against John Mack of Morgan Stanley who was allegedly systematically passing insider information to Art Samberg of Pequot Capital.

Why was Gary Aguirre fired, after receiving a glowing performance review? Why was there no enforcement action brought against John Mack / Morgan Stanley or Art Samberg / Pequot Capital? The insider trading penalties are some of the harshest the SEC has on the books, yet in this case, no action was taken. There was a closed door meeting between a lawyer representing Morgan Stanley and a senior staffer in the SEC. After this meeting, the insider trading case was not pursued further. This is a classic example of the selective application of justice.

(All of the above information was gleaned from public documents delivered to members of Congress and SEC Commissioners.)

This is a glaring example of the SEC's failure to provide equal protection under the law. Theoretically, in our country, all of us are supposed to receive equal treatment by our nation's civil authorities, whether it is a regulatory agency, a court, a jury, etc. Yet, in the case of the above insider trading scheme, and in the case of the thousands of naked short selling complaints, there has been a complete failure to apply the law consistently irrespective of the complainants economic status.

Therefore, given that you are newly appointed to the SEC and have an opportunity to apply the law equally and provide the middle class American with protection of their property, I strongly request that you turn a page in the history books of the SEC and provide Americans with an equal playing field in our nation's capital markets. Put rules in place that will actually terminate naked short selling abuses, and avoid those recommendations, such as the uptick rule, that are merely red herrings meant to mislead the uninformed public and lull them into a false sense of security with their retirement money.

If the SEC fails to act to protect shareholders from naked short sellers, the impoverishment of the American middle class will continue, and will destroy so much of what has made this nation great.

Kind regards,

Brian D. Pardo
Chairman & CEO
Life Partners Holding, Inc.

The Impact of a Pre-Borrow Requirement for Short Sales On Failures-to-Deliver and Market Liquidity

Robert J. Shapiro and Nam D. Pham

April 2009

SONECON

The Impact of a Pre-Borrow Requirement for Short Sales On Failures-to-Deliver and Market Liquidity[1]

Robert J. Shapiro and Nam D. Pham

I. Introduction and Summary

Since 1989, many investors, scholars and market analysts have urged the Securities Exchange Commission (SEC) to address the problem of failures-to-deliver ("fails" or FTDs) of shares sold short, or "naked" short sales. Since 2004, the SEC has taken a number of steps to discourage FTDs and encourage or require investors and broker-dealers to resolve their outstanding fails, principally through the provisions of Regulation SHO (Reg SHO) and its amendments. These efforts have reduced fails during certain periods, yet the numbers of fails also have periodically risen to record levels. Moreover, very large-scale naked short sales and the FTDs they produce played a role in the sudden and unmanaged collapse of Bear Stearns and Lehman Brothers, events which triggered the unprecedented financial and economic turmoil here and abroad of the past year. Despite stringent measures taken by the SEC during this crisis, fails continue to persist at levels greater than those that pertained before Reg SHO.

This analysis will examine why this problem remains so serious. We also analyze the benefits and costs of adopting an approach used in other national markets to prevent or eliminate most fails: Require that short sellers borrow the shares they plan to sell short before their sales are transacted. The data and other evidence will show that a "pre-borrow" requirement could virtually end naked short sales at little or no cost to the efficiency and liquidity of U.S. capital markets. Our findings include:

- Current regulation has not stemmed failures-to-deliver in meaningful ways. In the first three months of 2008, before the collapse of Bear Stearns, fails on any given day affected almost 4,000 companies and averaged more than 1.1 billion shares, or more than twice the average levels of both the previous year and the first 15 months of Reg SHO. These fails were sufficiently concentrated to affect share prices of many stocks: 100 companies or less than 3 percent of those with fails accounted for more than 70 percent of the fails.

- As the financial and economic crisis unfolded, FTDs increased sharply, reaching more than 2 billion shares in July 2008 with an estimated value of $30 billion, based on share prices one month before fails soared and helped depress prices. Using mark-to-market pricing, the value of fails increased by half from third quarter 2007 to third quarter 2008.

- These fails were linked closely to sharp increases in short sales, including those affecting Bear Stearns and Lehman Brothers. From first quarter 2007 to March 2008, short sales

[1] The research for this study received support from Overstock.com. The analysis and conclusions are solely those of the authors.

of Bear Stearns increased four-fold, to 23 million shares, while failures-to-deliver those shares increased 145-fold to 14 million shares or 59 percent of the stock's short interest. Despite the SEC's emergency measures to stem naked short sales, the same dynamics unfolded at Lehman Brothers: From third quarter 2007 to September 2008, short sales of Lehman increased four-fold to more than 100 million shares; and failures-to-deliver those shares increased 151-fold to 50 million shares or 46 percent of the stock's short interest.

- FTDs declined in the fourth quarter of 2008, compared to their historic highs at the height of the U.S. financial system crisis in the third quarter. While SEC regulation played a role, especially ending the options-maker exception to Reg SHO and thereby reducing fails in optionable threshold securities by 77.2 percent,[2] naked shorts and their attendant fails have remained at troubling levels. Average monthly fails of more than 525 million shares during the fourth quarter were greater than the average quarterly fails in the first year after Reg SHO was implemented and comparable to levels in mid-2006. Average monthly fails per-security of nearly 367,000 shares in the fourth quarter of 2008 also were higher than those reported during any other quarter since Reg SHO and nearly equal to those in the third quarter (372,000).

- While we should expect a decline in short interest and FTDs following a sharp decline in equity prices, regardless of regulation, measures other than average monthly levels of FTDs on a quarterly basis show fails remaining at very high levels in late 2008. Using SEC data to track maximum fails in December 2008 for companies with at least 10,000 fails, we find that despite the new close-out rules and the end of the options maker exception, maximum fails in December 2008 reached 885 million shares and maximum monthly fails over the fourth quarter averaged nearly 1 billion shares. (Figure 1, below)

- Moreover, fails have remained highly concentrated even as their total numbers decline. The number of companies with at least 10,000 fails, which reached 3,404 firms in July 2008, fell to 1,275 companies by December 2008.[3] However, the top 3 percent of those companies in July accounted for 73.9 percent of nearly 1.6 billion outstanding fails, or an average of 11.6 million fails each for that top 3 percent. In December, the top 3 percent of companies with at least 10,000 outstanding fails accounted by 79.0 percent of some 501 million total fails, or an average of 9.9 million fails each for the top 3 percent.

To examine further the broad impact of FTDs and their relationship to other market features, we built a database of 5,500 companies identified by the SEC as having at least 10,000 fails at some time during the period January 2007 to December 2008. Our database uses daily number of FTDs of each company in this set each day of each month, and calculates monthly FTDs based on the highest FTDs for each company in that month.

- The database establishes that large-scale fails are an economy-wide problem and not limited to stocks from one or a few sectors, or to shares traded on a particular exchange. Rather, these substantial fails are distributed widely across companies from every

[2] SEC, Office of Economic Analysis, "Impact of Recent SHO Rule Changes on Fails to Deliver," memo, March 20, 2009. The OEA memo uses daily average FTDs on two random days, July 17, 2008 and December 31, 2008.
[3] SEC, http://www.sec.gov/foia/docs/failsdata.htm.

economic sector, and listed on all major exchanges and over-the-counter markets. They also affect companies with market capitalizations ranging from micro-caps to large-caps, and companies with both high and low levels of insider ownership.

- The decline in fails in the fourth quarter of 2008 does not suggest that the measures already taken are sufficient: The fails remain at high levels, and the current measures will not assure that the system will be protected from experiencing enormous increases in naked short sales during a future sectoral or systemic meltdown.

- Regression analysis of this database also establishes a close relationship between short sales and fails, across sectors, exchanges, market caps and insider ownership. Despite the expectation of some observers that this connection would be limited largely to micro-cap technology companies traded over the counter, the analysis found strong correlations between higher short sales and higher fails in both the aggregate of all companies and in those in the consumer goods, financial and industrial goods sectors, in stocks traded on the NYSE and Nasdaq, and among large-cap, medium-cap and small-cap firms.

- Regression analysis of this database did *not* find a close or significant relationship between short sales and trading volume, suggesting that short sales are *not* a pertinent factor for a stock's liquidity and that other factors drive the liquidity of individual stocks and the overall market. This relationship was strong and significant *only* for companies in the consumer goods sector. The analysis found only a weak relationship of modest statistical significance between short sales and trading volume for basic materials companies, shares traded on the Nasdaq, and large and medium cap companies. However, there were no significant connections between short sales and trading volume in the other seven economic sectors, for stocks listed on the NYSE or traded over-the-counter, and for small and medium-cap companies.

- The database also shows that overall, financial companies, the focus of the SEC's recent emergency regulation of short sales, are generally *less* vulnerable to short sale abuses than companies in other sectors. Using FTDs as a share of short interest as a proxy measure for such abuse, the analysis found that over 2007 and 2008, fails-to-deliver represented 2 percent to 4 percent of short interest for among financial companies, compared to between 4 percent and 11 percent for non-financial companies.

- Using this measure, the analysis also found significant levels of abuse in all markets and across all market caps, but much higher levels for stocks traded over-the-counter and for micro-cap companies.

- In addition to the role of naked short sales and the fails they produce in the abrupt, unmanaged and widely disruptive collapse of Bear Stearns and Lehman Brothers, large scale FTDs were closely associated with the precipitous decline in the value of many companies that used floorless-convertible financings. The SEC also has noted the role of naked short sales in other cases of stock manipulation and damage to confidence in U.S. markets.

- We also examine recent research on the impact of naked short sales, including a new evaluation by the Australian Securities Exchange of new rules to sharply curb the practice: They found that naked short sales increased volatility in stock returns without producing more efficient prices. They further found that based on bid-ask spreads, trading volume and order depth, naked short sales may decrease market liquidity.

- Studies of the impact of the SEC's recent emergency rules for U.S. short sales further suggest that its strict regulation of short sales in financial firms, including a pre-borrow rule, did not impair market liquidity: Increases in bid-ask spreads in this period, for example, equally affected stocks subject to and not subject to the new restrictions.

- The experience of the Hong Kong market supports these studies and the implication of our regression analyses that a pre-borrow requirement for short sales would not damage market liquidity. Over the 10 years since 1998, when Hong Kong applied a pre-borrow requirement along with uptick rules and strict short-sale disclosure and audit measures, daily trading on the Hong Kong exchange increased 172-fold, and the average daily value of those trades rose 111-fold. Hong Kong markets also avoided the steep spike in short sales and FTDs that occurred in other markets following the Lehman Brothers collapse.

- Finally, we find that the application of a pre-borrow requirement would not entail additional costs for short sellers, since current law and regulation already require short sellers to bear the cost of borrowing and delivering the shares they sell short.

We conclude that the current regulation of short sales has not effectively controlled failures-to-deliver and the naked short sales which usually produce them, imposing large costs on the shareholders of many companies across economic sectors, exchanges and market caps. We further conclude that naked short sales and the FTDs they produce played a significant role in the abrupt and unmanaged collapse of the financial institutions which in turn triggered the current U.S. and global financial and economic crisis. We conclude that new regulation of short sales, including pre-borrow requirements, should be able to effectively control naked short sales and failures-to-deliver at no appreciable cost to the liquidity or efficiency of American markets.

II. SEC Initiatives to Address Failures-to-Deliver and Naked Short Sales

After nearly 15 years of investor complaints, hearings and investigations of FTDs and naked short sales, the SEC took its first major action in this area since the 1930s in July 2004, when it adopted Regulation SHO. Reg SHO took effect in January 2005, but it left a number of aspects unaddressed, which limited its effectiveness. In particular the original regulation included "grandfather" clauses which exempted from mandatory resolution both those fails which preceded Reg SHO and fails which accumulated during the five-day period that triggers a stock's designation as a "threshold security" subject to Reg SHO requirements. The SEC closed these grandfather clauses in June 2007. Nevertheless, SEC data showed that FTDs continued to rise. In April 2008, the SEC proposed stricter regulation, declaring it unlawful for a short seller to deceive a broker-dealer about the investor's intention or ability to deliver a security sold short, but also held that sellers would not be liable for relying on their broker dealers to borrow shares.

The Commission also has affirmed the threat that naked short sales can pose to individual companies and the integrity of the financial markets. In July 2006, for example, the SEC noted,

> ... we are concerned that large and persistent fails to deliver may have a negative effect on the market in these securities ... they can be indicative of manipulative naked shot selling, which could be used as a tool to drive down a company's stock price.[4]

These concerns reflect a long history of manipulative, large-scale naked short sales. The most widespread instances of such abuses occurred in the death-spiral financing schemes of the latter 1990s and early years of this century, when large-scale naked shorts were used to damage up to hundreds of companies. Our research into 357 instances of death-spiral financing found that within one year of entering such financing agreements, 355 of the 357 companies declined in value. Adjusted for changes in the market over the same periods, these stocks subjected to large-scale naked shorts lost on average 68 percent of their market value in the first year.[5]

Moreover, large incidences of FTDs have persisted since the eclipse of death-spiral financing and throughout the period of the Reg SHO reforms. For example, we conducted a survey of stocks listed as Reg SHO threshold securities over the first 15 months of the regulation, from January 7, 2005 to April 3, 2006. Over this period, 500 NYSE companies and 516 Nasdaq companies were designated threshold securities, reflecting in each case fails of at least 10,000 shares accounting for at least 0.5 percent of their outstanding shares.[6] SEC data showed that the Regulation was not achieving its purpose: Nearly 30 percent of the NYSE threshold securities and 25 percent of the Nasdaq threshold securities remained on the list for more than 18 days, the period by which Reg SHO intended to force the resolution of outstanding fails. Moreover, 48 companies from the two exchanges remained on the list with large numbers of unresolved fails for at least 60 consecutive trading days. And in the closing months of this 15-month period, total outstanding fails averaged about 500 million shares on any given day, greater than in the months before Reg SHO and with an average duration longer than before Reg SHO.

The SEC recognized shortcomings in the original regulation and adopted a series of additional amendments. In June 2007, SEC Chair Christopher Cox called naked short sales, "a fraud that the commission is bound to prevent and to punish." At that point, the Commission amended Reg SHO to eliminate the "grandfather" clauses, so that all then-outstanding fails had to be resolved within 35 days, including those created before Reg SHO and those accumulating during the five-day qualifying period for inclusion on the Reg SHO threshold list. They further directed that all subsequent fails in threshold securities should be closed out in 13 trading days.

These new measures failed to stem the problem. SEC data for the first three months of 2008 show that on any given day of that period, almost 4,000 companies had outstanding fails of at least 10,000 shares, totaling on any given day an average of 1.3 billion shares – more than twice the monthly levels in the first 15 months of Reg SHO. Even before the financial crisis

---

[4] SEC, 17 CFR Part 242, Release No. 34-54154, www.sec.gov/rules/proposed/2006/34-54154.pdf.

[5] Cited in Comments on Proposed Amendments to Regulation SHO, Rule Number S7-12-06, Robert J. Shapiro, September 14, 2006; http://www.sec.gov/comments/s7-12-06/rjshapiro5967.pdf

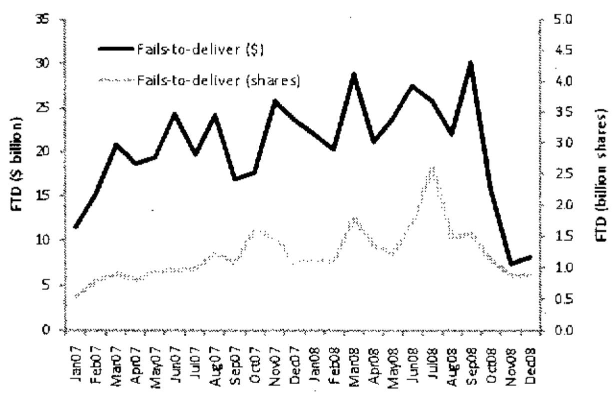
[6] *Ibid.*

erupted in March 2008, the number of firms with large fails and their total fails both were rising. For example, the sum of the maximum fails in stocks with at least 10,000 fails in January and February 2008 totaled 1.1 billion shares in each of those months. By March 2008, outstanding fails surpassed 1.8 billion shares, a 60 percent increase over January. (Figure 1, below)

The SEC fails data also show that these huge FTDs were concentrated in a relatively small number of stocks. In the first three months of 2008, 100 companies, or about 3 percent of those with at least 10,000 fails, accounted for 70.5 percent of total fails, or 735 million fails out of an average total of 1.1 billion fails. By March of 2008, the top 3 percent or 100 stocks with at least 10,000 outstanding fails each had an average of 9,306,640 shares that had failed to deliver. And in December 2008, the top 40 companies or about 3 percent of the 1,275 firms with at least 10,000 outstanding fails that month still accounted for 79.0 percent of total fails, with an average of 9,902,200 shares each that had failed to deliver.[7]

The financial crisis has increased interest in the incidence of naked short sales and the damage they can inflict on companies and investor confidence in the securities markets. The number of outstanding fails, which stood at some 550 million shares in January 2007 and more than 1.1 billion shares in January 2008, jumped to over 2 billion shares by July 2008. The value of these fails jumped nearly as much, from $12 billion in early 2007 to $30 billion in July 2008.[8]

Figure 1: Fails-to-Deliver -- Dollar Amounts and Number of Shares, January 2007 – December 2008



As evident in the figure above, FTDs declined in the fourth quarter of 2008, compared to their historic highs at the height of the U.S. financial system crisis. SEC regulation played a clear role in this decline, especially by ending the options-maker exception to Reg SHO, which reduced fails in optionable threshold securities by 77.2 percent.[9] Moreover, a sharp decline in equity prices would be expected to produce a decline in short interest and FTDs, apart from regulation changes. , measures other than average monthly levels of FTDs on a quarterly basis

[7] SEC, http://www.sec.gov/foia/docs/failsdata.htm.

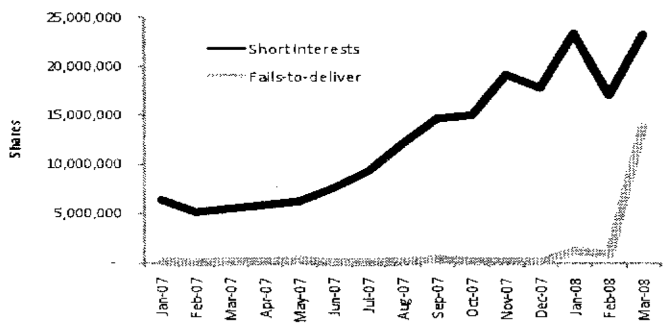
[8] Unless noted, monthly FTD data in this report represent the sum of highest FTD per-company within that month.

[9] SEC, Office of Economic Analysis, "Impact of Recent SHO Rule Changes on Fails to Deliver," memo, March 20, 2009. The OEA memo uses daily average FTDs on two random days, July 17, 2008 and December 31, 2008.

show fails remaining at very high levels in late 2008. However, naked shorts and their attendant fails still remained at troubling levels, averaging on a monthly basis more than 525 million shares over the fourth quarter or higher levels than the average quarterly fails in the first year after Reg SHO was implemented and comparable to levels in mid-2006. The average monthly fails per-security of nearly 367,000 shares in the fourth quarter of 2008 also were higher than any other quarter since Reg SHO was put in place, except for the third quarter when those levels averaged 372,000 shares. Further, other measures of FTDs show fails remaining at even higher levels in late 2008. Using SEC data to track maximum fails of companies with at least 10,000 fails in December 2008, we found that despite the new close-out rules and the end of the options maker exception, this maximum fails measure reached 885 million shares in December 2008 and averaged nearly 1 billion shares over the fourth quarter.

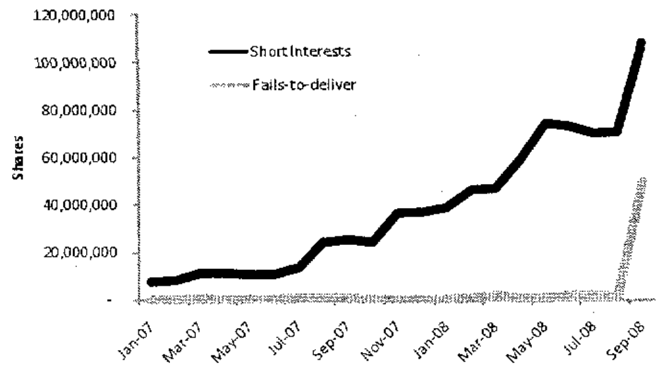
There also is strong evidence that naked short sales played important roles in the pivotal failures of the crisis, starting with Bear Stearns. By the time of Bear Stearns' collapse in March 2008, its short interest had soared four-fold, reaching more than 23 million shares, compared to average short interest of 5.5 million shares over the three-month period of the previous year (February-March-April 2007). Moreover, fails-to-deliver of the rising numbers of Bear Stearns shares sold short soared even more, from average levels of less than 100,000 shares in February-March-April of 2008 to 14 million shares in March 2008, an increase of 145 times. These data show clearly that Bear Stearns was a target of massive, naked short sales, and it is virtually certain that they helped precipitate its sudden and unmanaged collapse. (Figure 2, below)

Figure 2: Bear Stearns – Short Interests and Fails-to-Deliver, January 2007 – March 2008



Following Bear Stearns, the SEC took a number of additional steps to address the problem. On July 15, 2008, the Commission imposed a temporary pre-borrow requirement on short sales in 19 major financial firms, although three days later it exempted market makers and derivative positions. These restrictions did not prevent massive short sales and naked short sales of many companies, including Lehman Brothers which folded on September 15, followed by AIG on September 16. Rather, the sudden collapse of Lehman Brothers followed a pattern nearly identical to Bear Stearns. Moreover, this time, it triggered the systemic financial crisis that continues to exact enormous damage on the American economy, the value and operating capacity of thousands of companies, and the wealth and security of tens of millions of households. By September 15, 2008, when Lehman Brothers filed the largest Chapter 11 bankruptcy in the U.S. history, its short interest had risen to nearly 100 million shares, some four times its average short interest of 24 million shares in the corresponding quarter of the previous year (August-September-October 2007). Moreover, just like Bear Stearns, the incidence of fails-to-deliver of Lehman Brothers shares soared to an even much greater degree, increasing 150-fold from an average of 220,000 shares in August-September-October of 2007 to 50 million shares in September 2008. (Figure 3, below)

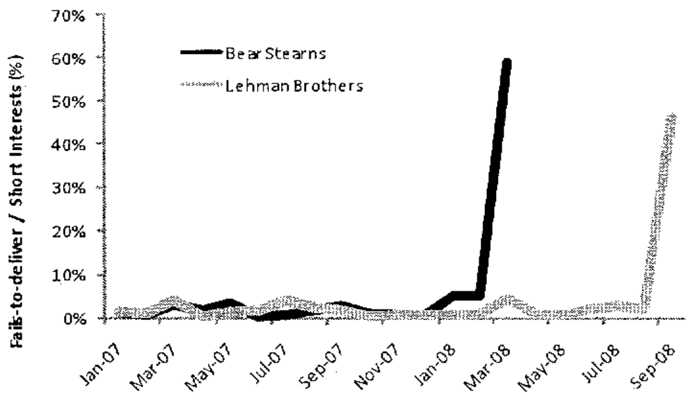
Figure 3: Lehman Brothers – Short Interests and Fails-to-Deliver, January 2007 – September 2008



In both of these cases, the incidence of fails-to-deliver soared in the month prior to the companies' destructive collapses. Based on their share prices in the month before their collapse, the value of their fails, most of which almost certainly arose from naked short sales, exceeded $1 billion in each case.[10] Moreover, the FTDs of Bear Stearns shares in March 2008 represented 59 percent of the company's total short interest, compared to an average of 1 percent in 2007. Similarly, the FTDs of Lehman Brothers shares in September 2008 represented 46 percent of the company's short interest, compared to an average of 2 percent in 2007. (Figure 4, below) While the crisis doubled legitimate short sales in these stocks, it appears to have produced an avalanche of abusive, naked short sales – increases of 14,500 percent to 15,000 percent, compared to the previous year averages.

[10] Bear Stearns was traded at $80 per-share in February 2008, one month before the collapse. Lehman Brothers shares were traded at $20 per-share three-months before the collapse in September 2008 and in the range of $40 per-share during the second quarter of 2008, following Bear Stearns' collapse.

**Figure 4: Bear Stearns and Lehman Brothers,
Fails-to-Deliver as a Share of Short Interest, January 2007 to September 2008**



We conclude that massive, naked short sales precipitated the sudden failures of these firms and the catastrophic financial and economic damage triggered by their abrupt collapse. While both firms would likely have failed in any event, a strictly-enforced pre-borrow requirement could have prevented the massive, naked short sales and enabled their executives and federal officials to manage their restructurings or liquidations in an orderly way. Under those conditions, the collateral damage to the financial markets and the overall economy could have been much better contained.

The SEC recognized this pattern and on September 17, 2008, two days after Lehman Brothers' collapse, issued new rules imposing additional penalties on those who fail to deliver shares sold short and proposed new requirements that hedge funds and other large investors disclose their short trading positions. The Commission also adopted Rule 204T accelerating close-out requirements and expanding the scope of Reg SHO beyond threshold securities to cover all equities. Under the new rules, a broker dealer that fails to deliver shares in any transaction may not engage in additional short sales in that security without a pre-borrow or a clear and specific agreement to borrow the security. The new rules also temporarily removed the existing exception for option market makers.

Two days later, the SEC temporarily halted short sales of 799 financial stocks and directed money managers to report new short sales in certain other securities. In the United Kingdom, the Financial Services Authority (FSA) took similar measures, barring short sales in financial institutions and requiring public disclosure of all substantial net short positions in these companies. Within the week, Germany, Australia, Taiwan, Korea, and the Netherlands suspended short sales in either financial companies or all companies.

The SEC lifted the ban on short sales in financial stocks on October 6, 2008; over the next two weeks, the Commission permanently eliminated the options market maker exception from Reg SHO, enhanced delivery requirements for equity securities, and narrowed the definition of bona-fide market-making transactions exempt from delivery requirements. Despite these measures, SEC data show that FTDs two months later were still higher than during the first six months of 2007: In December 2008, FTDs averaged on any given day nearly 900 million shares, with a total value of more than $8 billion. (Figure 1, above) Moreover, there is little basis for confidence that these measures would prevent a recurrence of the events of March and September 2008.

Next Steps for the SEC

The continuing persistence of FTDs and the prospect of additional problems in the future suggest that the SEC should reform the basic mechanism for short sales. The most effective and efficient mechanism for this purpose, in our view, would be to apply a strict pre-borrow requirement to all short sales of the kind implemented by financial authorities in some other countries and recently called for by five U.S. Senators.[11]

To examine the basis and implications of such a change, we analyze the incidence and effects of FTDs across the markets using SEC daily FTD data for 5,500 companies reporting 10,000 or more fails at some time during 2007 and 2008, supplemented with additional data on these companies from commercial sources. Our analyses find that short sales and FTDs are positively and strongly correlated, not only among large financial institutions but across the sectors of the economy, the major exchanges, and varying market capitalization and degrees of insider ownership. Our analysis further finds that short sales and overall trading volume are correlated only weakly and in limited areas of the market. The data also show that the recent high incidence of naked short sales and FTDs among financial companies occurred in other sectors as well. Based on these results, concerns about the impact of naked short sales the FTDs they produce apply to all sectors and markets, not just finance, as should reforms to sharply reduce their incidence and impact.

The analysis suggests further that a pre-borrow requirement could curb abusive naked short sales without impairing legitimate short sale activity or imposing any significant costs on the efficiency of U.S. equity markets. Legitimate short sellers would bear no additional costs: Their direct costs from a pre-borrow requirement – the cost of borrowing the shares – will be the same as the costs which they already bear under SEC regulation to carry out their short sales. Additional analysis and the record of other national markets with pre-borrow requirements also show that this reform would entail little if any reduction in the overall liquidity of the markets. Moreover, to the degree that the requirement reduces overall short sales by reducing naked short sales, the resulting liquidity would reflect more accurately the underlying economic conditions, enhancing the market's efficiency. As no one could reasonably hold that market efficiency should be enhanced by allowing investors to sell shares long without owning and delivering them, its efficiency is not supported by allowing investors to sell shares short without borrowing and delivering them. Especially in light of the damage which abusive naked short sales exact on individual companies, their shareholders and, under certain conditions, the financial system, a pre-borrow requirement applied to short sale transactions should produce significant net benefits for shareholders and the integrity of the U.S. market process.

---

[11] Letter to SEC Chair Mary L. Schapiro from Senators Saxby Chambliss, Johnny Isakson, Edward Kaufman, Carl Levin and Jon Tester, April 1, 2009. Senator Arlen Spector also signed the letter, but focused on restoration of the uptick rule.

III. The Benefits and Costs of Short Sales

The need for a pre-borrow requirement should not be taken to suggest that legitimate short sales damage or impair the operations of capital markets, or that short sales should be bound in ways other than those directly supporting the conditions which render them legitimate. Short sales vitally enhance public information flows about public companies and thereby contribute substantially to the efficient operations of financial markets. They promote price discovery by providing a way for market participants to profit from the knowledge or view that a company's share price is overvalued and the consequent expectation that its share price will decline. Without short selling, stock prices would be biased by the views of buyers because only investors who already own shares in a company could convey negative views about that company by selling their shares. As a result, stock prices would not fully incorporate the negative views of all market participants.

Short sellers accept larger risks than those who own a stock, for while the risk to an owner of holding his or her shares is capped at the original purchase price, the risk for a short seller can be much greater if the stock goes up sharply. The value of the information conveyed through a short sale depends upon this economic risk which the short seller bears. Prudent traders short companies with poor fundamentals, such as book to value or earnings growth, or the expectation of poor earnings or company turmoil.[12] Market observers assume that most short sellers are at least as prudent as other investors – or even more so, given their greater risk – and therefore often use a stock's short interest to gauge a company's potential downside. A sudden and substantial increase in the volume of a stock's short sales, therefore, can be a powerful red flag for other market participants; and equity analysts often downgrade companies with high and unexpected levels of short sale activity. While the shares of most troubled companies would decline eventually without short sellers, their activities can uncover those troubles sooner, reducing the likelihood of companies remaining overpriced for sustained periods.[13]

Academic research supports these general views. While an early study concluded that short sales produce an upward bias in stock prices (Miller, 1977), subsequent analyses rebutted these findings (for example, Diamond and Verrecchia, 1987). Researchers also established that high and unexpected short interest results in downward revisions in forecasts, compared to firms with lower short interest (Francis *et. al.*, 2005); and that firms whose ratings are downgraded following high short sale activity also experience declines in operating income.[14] Moreover, very recent studies have not found any strong evidence that the 2008 restrictions on short sales in various countries altered stock returns in major global markets (Marsh and Neimer, 2008).[15]

Just as do long sales and purchases, legitimate short sales represent a contract in which a buyer pays a seller, and the seller delivers the shares which the buyer has purchased, but by borrowing them. Without borrowing and delivering the shares, the contract is fraudulent and

---

[12] Dechow, Patricia, Hutton, Amy, Meulbroek, Lisa and Sloan, Richard, "Short-Sellers, Fundamental Analysis, and Stock Returns," *Journal of Financial Economics*, 2000.

[13] Culp, Christopher and Heaton, J.B.,"The Economics of Naked Short Selling," *Regulation Magazine*, 2008.

[14] Francis, Jennifer, Venkatachalam, Mohan and Zhang, Yun, "Do Short Sellers Convey Information About Changes in Fundamentals or Risk?" 2005.

[15] Marsh, Ian W. and Niemer, Norman, "The Impact of Short Sales Restrictions," 2008 provides a comprehensive literature review.

thereby diminishes the market's efficiency. The requirement to borrow shares which a seller has sold short also sustains the integrity of a company's capitalization, by requiring that short sale transactions involve the actual exchange of shares registered with the SEC.

Naked short sales violate all of these terms. A buyer pays a seller but the seller fails to borrow and deliver the shares the buyer has paid for. This illegitimate transaction distorts the meaning of the company's capitalization since no shares registered with the SEC are exchanged in the transaction. Some fails-to-deliver represent human or mechanical errors or processing delays of paper certificates. However, the use of electronic shares and notations for 97 percent of all trades and the operations of the continuous net settlement system ensure that these inadvertent FTDs represent only a very minor share of all fails. Research and logic both establish that large-scale sustained fails are both intentional and carried out for illegitimate reasons, either to avoid the borrowing costs that other short sellers bear, or to advance an effort to manipulate a stock's price. In the first case, the naked short seller unilaterally claims an economic advantage over investors who respect SEC and exchange rules. In the second instance, naked short sellers may flood the market for a company's shares with sell orders, and in examples such as Bear Stearns, Lehman Brothers and many less infamous cases, artificially drive down the value of a company's shares, harming its shareholders.[16] In both cases, the SEC has noted that the naked short sellers' ability to avoid borrowing costs grants them greater leverage than legitimate short sellers, and they can use this enhanced leverage to engage in larger trading that can result in the manipulation of share prices.[17]

For these reasons, the SEC has repeatedly denounced the practice of naked short sales. In 2006, long before the large-scale naked short sales of pivotal financial institutions in 2008, the Commission wrote that "large and persistent fails to deliver" can be "indicative of manipulative naked short selling, which could be used as a tool to drive down a company's stock price" and "the perception of such manipulative conduct also may undermine the confidence of investors. These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to such manipulative conduct."

In this last comment, the SEC notes correctly that naked short sales, far from enhancing market liquidity, can actually reduce it. This contrasts with the contribution of legitimate short sales to the market's overall efficiency by expanding the number of investors willing to sell shares at any moment. When a market experiences significant and temporary buying pressures, short sellers often respond, with an expectation that as the buying pressures subside, share prices will revert to their fundamental values, and the short sellers will be able to purchase the shares to cover their positions at lower prices.[18] The high incidence of short sales in U.S. markets in recent years attests to their significance: A survey of all sales on the New York Stock Exchange (NYSE) during the first quarter of 2007, for example, found that about 25 percent of all shares traded were sold short. Unsurprisingly, a recent study found that the emergency ban on short

---

[16] Amendments to Regulation SHO, Release No. 34-58773, Securities and Exchange Commission, October 17, 2008.

[17] Security and Exchange Commission, "Short Sales, Proposed Rule," Release No. 34-48709, October 29, 2003.

[18] Diether, Karl, Lee, Kuan-Hui Lee and Werner, Ingrid, "Short Sale Strategies and Return Predictability," *The Review of Financial Studies*, 2007.

sales of 19 major financial institutions increased their price volatility (Bris, 2008).[19] These results are amplified by other researchers who found decreased trading volume and fewer trades during the 17 trading days of the short-sale ban, compared to the 17 trading days prior to the temporary ban – and not only for the 19 targeted companies, but for all stocks (Boulton and Braga-Alves, 2008).[20]

IV. The Impact of a Pre-Borrow Requirement: Empirical Evidence and Analysis

To evaluate the impact of a pre-borrow requirement on short sales and market liquidity, we assembled a database using daily fails-to-deliver data collected by the National Securities Clearing Corporation's (NSCC) Continuous Net Settlement (CNS) and reported by the SEC, from January 2007 to December 2008. A stock's number of fails on any given day, T, represents the cumulative fails in that stock outstanding until T, plus new fails that occur on T, less old fails that settle on T. To use these SEC daily FTD data along with short interest data reported on a monthly basis, we use the high fails reported each month for each company to represent its fails in that month. These data, however, underestimate both the number of companies with fails and the total FTDs in the market, because the CNS reporting system includes only companies with at least 10,000 FTDs on any given day. Moreover, these data also do not include ex-clearing trades which occur outside the CNS reporting system, with attendant FTDs, which may be very substantial. With these caveats, the NSCC data show approximately 5,500 companies with at least 10,000 FTDs at some point over those two years. We use this list of 5,500 companies with their fails and data collected on each company identifying its primary sector, its listed exchange, its short interest, its outstanding shares, its trading volume and market capitalization, and the extent of its insider ownership.

This database shows that fails-to-deliver are a very broad-based phenomenon and problem. The data show, first, that significant FTDs are distributed across every economic sector. The 5,500 companies were distributed as follows: 10.3 percent in basic materials; 0.3 percent in conglomerates; 7.4 percent in consumer goods; 26.3 percent in financial sector; 11.7 percent in healthcare; 6.1 percent in industrial goods; 17.3 percent in services; 18.8 percent in technology; and 2.0 percent in utilities. The database also shows that more than half of all companies with substantial FTDs over the two-year period were listed on the major exchanges: 28.0 percent were listed on NYSE/AMEX, 25.4 percent were listed on Nasdaq; and 46.6 percent were traded over-the-counter.[21]

We also disaggregated the 5,500 companies by their market capitalization, using four categories: Large cap (more than $5 billion); medium cap ($1 billion-$5 billion); small cap ($300 million-$1 billion); and micro cap (less than $300 million). As we will see, these data show that companies of all sizes experience substantial FTDs, but large-scale fails are fairly concentrated in very small companies. Mirco cap companies accounted for 62 percent of the 5,500 companies, compared to 9 percent for the large caps, 13.3 percent for the medium caps, and 15.7

[19] Bris, Arturo, "Short Selling Activity in Financial Stocks and the SEC July 15th Emergency Order," Working Paper, 2008.
[20] Boulton, Thomas J. and Braga-Alves, Marcus V., "The Skinny on the 2008 Naked Short Sale Restrictions," Working Paper, December 2008.
[21] NYMEX figures include AMEX trading activities, which accounted for 4.7 percent of the total figures.

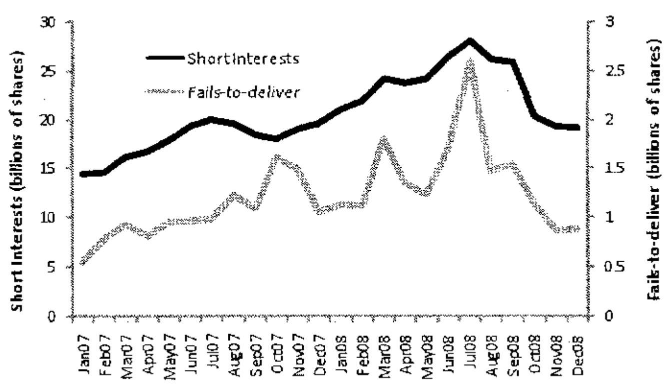
percent for the small caps. This finding is particularly troubling, because micro cap companies are more easily subject to share manipulation through naked short sales than larger companies.

We also divided the companies in the database according to whether insiders held relatively large or relatively small shares of the company's stock. In April 2008, insiders held an average of 22.5 percent of the shares of U.S. companies. Using this measure, we divided the 5,500 companies into those with 22.5 percent or more insider ownership, and those with less than 22.5 percent insider ownership. Of the 5,500 companies with substantial FTDs, 38.7 percent had higher than average insider ownership, and 61.3 percent had less than average insider ownership.

The Relationship of Short Interest and Fails-to-Deliver

The SEC Office of Economic Analysis (OEA) has found a strong correlation between trading volume and fails.[22] These results are important, but they do not bear directly on the issues examined here. One claim sometimes made by opponents of additional regulation is that fails are tied closely to overall short sales, and therefore attempts to end fails may also reduce overall short selling, impairing liquidity. There is no evidence that the results found by the OEA suggest that restrictions on fails would impair overall trading volume and therefore market liquidity. Rather, the data show that since short sellers are not currently required to pre-borrow the shares they sell short, higher short selling activity is accompanied by even greater increases in fails-to-deliver – and vice versa. From January 2007 to July 2008, short interest nearly doubled from 14.5 billion shares to 28 billion shares, while FTDs increased much more sharply, rising five-fold from 500 million shares in January 2007 to 2.5 billion shares in July 2008. Following the SEC restrictions on short sales, beginning in July 2008, short interest declined 30 percent from its July peak of 28 billion shares to about 20 billion shares in December 2008. Over this period, fails fell more rapidly, declining by two-thirds from a peak of 2.6 billion shares in July 2008 to less than 900 million shares in December 2008. (Figure 5, below)

Figure 5: Short Interest and Fails-to-Deliver, 2007-2008 (billions of shares)



[22] SEC, Office of Economic Analysis.