

S7-12-06 Comments to proposed changes to Reg SHO.
David Matthews
August 19, 2006

It is good that the SEC is addressing some of the problems with failures to deliver (FTD). That you are only taking these actions after two years of observation of the problems of Reg SHO and only after Congressional inquiry leaves doubts as to your dedication to correcting the problem. While the grandfather problem is huge for a small number of companies, it is not the main problem and your emphasis on it distorts the more significant problem of FTDs in the system.

Those entities that have long-standing FTDs (i.e., were grandfathered previously) are already on notice that they will no longer be allowed to continue to not deliver the securities they have sold. There should be no need for another 35 day grace period for them to comply. Two weeks or 10 trading days should be sufficient. If it would adversely affect them (and I see no reason why that should be of any concern since they have been in violation of the law for a substantial period of time already), they have plenty of time to close out their positions ahead of the implementation of the rule change.

Obviously, the capability of FTD allows naked short sellers to increase the supply relative to whatever demand may exist and to overwhelm any amount of demand if so desired by the short sellers. It is desirable to have some elasticity in demand and this is provided by allowing borrowing of securities, effectively limiting the supply to no more than double the actual supply and normally much less. Even short-term disruptions of the supply-demand curve can lead to substantial windfall profits for those able to control the supply through naked shorting. No such opportunity exists for the demand side of the equation. And, in fact, the public can never short a stock unless the shares are available in advance for borrowing by the brokerage house.

I therefore favor much more strident limitations on naked short selling than proposed Rule SHO changes. Anyone who has failed to deliver should certainly **not** be allowed to continue selling short until they deliver the shares they did not. The time period before the rule would take effect should be shortened substantially. Today, they have 5 days after the FTD before the stock is placed on the SHO Threshold list and then another 13 days to deliver, during which time they are free to sell short whatever they please. Even after that, they can continue shorting the stock if they can deliver the shares. And this is only if the rule is rigidly enforced, and it appears such enforcement is not taking place on a routine basis.

A short seller already has three days to deliver. A short delay of 7 calendar days should be ample for legitimate delays after which time a penalty should take effect. That is, the person should no longer be allowed to sell that security short **at all** until the delinquent delivery has been corrected.

There may be a legitimate case, such as short sales in advance of anticipated conversion of convertible notes, where it may legitimately take a week to convert and obtain the shares from the company, but this is an obvious and easily handled exception that is of no concern to anyone since the shares are going to be delivered as soon as possible. It may still be in everyone's best interest to limit this kind of delay to the 7 calendar days mentioned in the previous paragraph to insure there is no abuse of the rule.

The fixed 0.5% threshold leaves too much room for manipulation beneath the radar of the rule. Many stocks are tightly held and have a float significantly less than the number of shares outstanding. Further, in many cases, the number of shares actually traded is only a small fraction of those available in the float. Hence, selling short without intention to deliver of 0.5% of the outstanding shares, may in fact allow substantial control of the share price by those doing the naked shorting without ever coming under control of the current rule. The rule must be implemented such that this cannot occur. With modern computers, there is no reason for any threshold. It is easily within your capability to monitor each and every naked short sale. There should be **no** naked short selling, period.

The SEC is clearly allowing substantial manipulation of many stocks and I believe the problem is much worse than reported due to the design of the threshold test currently in place. It is time to take decisive action. If you choose to continue to apply minimal regulation of these practices, which are in clear violation of the 1934 securities act, then Congress will once again have to step in and mandate changes.

I would add that by failing to act and, in effect, looking the other way, the SEC is a silent partner in these schemes to defraud the American people. It is also a corruption of the free enterprise system. It is time for a change.

David Matthews