NCANS

National Coalition Against Naked Short Selling - Failing to Deliver Securities

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Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

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RE : Amendments to REG SHO *Release No.:* 34-54154, *File No.:* S7-12-06

Ladies and Gentlemen:

Thank you for providing an opportunity for concerned investors to comment on the proposed amendments for Regulation SHO.

NCANS – Who We Are

NCANS is a grassroots organization born of necessity. We are supported by and composed of investors on the receiving end of the negative consequences of naked short selling, long-term unsettled trades, and failed securities entitlements.

In addition to investors and participants, our members include corporate executives concerned about the deleterious effect these practices have on their companies, employees and investors, and their negative impact on corporate governance issues like shareholder votes.

We endorse Section 9 of the 1934 Securities Exchange Act, which makes it unlawful to effect any securities transaction which involves no change in beneficial ownership, and Section 17A, which stresses the need for the linking of all clearance and settlement facilities, and stipulates the prompt clearance and settlement of securities transactions, including the transfer of record ownership. We further endorse U.C.C. Article 8, which requires that security entitlements be supported by bona fide securities on a one-for-one basis, for as long as the security entitlement is held - a prudent and common-sense requirement to prevent abuse at the security entitlement level. And we particularly appreciate Section 36 of the 1934 Act, which allows the SEC to create exceptions to the 1934 Act, "*…to the extent that such exemption is necessary or appropriate in the public interest, and <u>is consistent with the protection of investors</u>…*" (emphasis added).

NCANS' position is that Reg SHO in its current form fails to satisfy the essential requirements described in those sections and articles, and therefore fails to have due regard for the public interest, the protection of investors, the safeguarding of securities and funds, and the maintenance of fair competition among brokers and dealers, clearing agencies, and transfer agents.

Scope of the Problem

Between 700 Million and 1.5 Billion (known via in-clearing data from the DTCC, obtained through FOIA requests) undelivered equity securities are outstanding on any given day in the U.S. equities markets, not including "ex-clearing" failures. This is the minimum (and likely substantially low) number, given that there is strong evidence that netting eliminates the need for settlement in the vast majority of transactions. Those are a lot of undelivered securities - for which investors have paid, and commissions and fees have been collected.

For the sake of market integrity, investor protection, and the reputation of U.S. markets, SEC rules need to align with the requirements of the 1934 Securities Exchange Act, U.C.C. Article 8, state securities laws, and international securities exchange standards. We believe the U.S. equities markets cannot function properly unless the SEC's rules are consistent with their fundamental principles: namely, for the prompt delivery of genuine securities *in all cases*; for even application of rules and law across *all* investor and participant types; for a *one-for-one ratio* of genuine securities to securities entitlements; for *transparency*; and for *meaningful penalties* when violations occur.

The SEC must stop allowing one subset of investors/participants to profit at the expense of others. Example: Derivatives (options) market makers lay off their hedging expense and risk exposure on the equities markets by failing to deliver equity securities in "put" option hedging scenarios. This benefits the derivatives market and its participants, at the expense of equity investors and issuers. Derivatives market liquidity cannot be supplied via delivery failures (and resultant investor harm) in the equities market. This abuse of one class of investors for the benefit of derivatives market participants must end. Nowhere is the SEC empowered to favor one business or market's interests at the expense of the investing public.

The theme that runs through this comment letter is that the SEC must hold investor protection, transparency, and the operation of a fair and equitable market system, above the interests of market participants. Those interests include liquidity at the cost of market integrity, opacity rather than transparency, and exceptions from rules designed to protect investors.

We believe delivery failures will continue harming investors until the SEC takes comprehensive and decisive action, and implements basic market principles comprised of universal <u>locate</u> and universal <u>delivery</u> requirements, in tandem with universal <u>buy-in</u> requirements - without exceptions for any class of participants.

In addition to equity securities, Reg SHO and these universal requirements should also cover security entitlements, ensuring prompt delivery of genuine securities for <u>all</u> credited security entitlements. Otherwise, Reg SHO and any amendments will be easily circumvented by effecting naked short sales using failed security entitlements – crediting customer accounts with security entitlements for which no bona fide securities exist, and failing to cancel those entitlements when the underlying securities fail to materialize.

While the SEC and the DTCC argue that the scope of the delivery failure problem is inconsequential, they do so in oblique, statistical terms; as percentages of all trades, or number of transactions, or mark-to-market value of only "in-system" delivery failures (omitting "ex-clearing" failures as outside of the regulatory and reporting framework), rather than in a straight-forward manner that would allow verification and significant analysis. The SEC has often taken the position that meaningful reporting of delivery failures to investors and issuers would violate "trade secrets" or "proprietary trading strategies" – again holding the interests of certain participants as superior to those of investors. In the SEC's request for comments, it indicates that any response to its questions about delivery failures should contain data to substantiate proposals – ignoring that the DTCC and the SEC make virtually no meaningful data available. There is a spectacular opacity to the workings of the clearing and settlement system, and that lack of transparency benefits nobody but those abusing the system. The lack of material reporting must end, and investors and issuers must be able to get timely, current data on short selling and delivery failures – or the regulatory bodies are shielding participants at the expense of investors and issuers.

The equities markets can no longer tolerate large numbers of delivery failures, nor failures to obtain securities for security entitlements credited to investor accounts. The double standard for participants and market makers has resulted in a growing tide of resentment among issuers and investors, and the aforementioned inequities are denigrating the reputation of the system. With U.S. markets slipping from 48% to 41% of total investor world capital, and the reduction of IPO activity in the U.S. (as issuers seek more hospitable venues for their public debuts), NCANS believes the slide will accelerate as the U.S. market reputation weakens, and the delivery failure issue gains visibility.

As an interesting historical footnote, when one looks up the history of the NYSE, the chronology reads, "February 1, 1832 – Buying in for non-delivery authorized." The concept that delivery failures can't be tolerated in a fair market, and must be made good via buy-ins, is nothing new. 175 years ago the exchange and participants knew this essential and obvious truth. It is therefore troubling to NCANS' members that a discussion about prompt delivery rules is taking place in 2006, and amendments to delivery rules are being contemplated that still contain exceptions for certain classes of participants, as well as lack any concrete requirement to buy-in failed deliveries.

NCANS Not Anti-Short Selling

To be clear, NCANS is not against short selling, as we believe that short selling can be a beneficial investment strategy, and can enhance investor returns. Neither is NCANS against short-term delivery failures resulting from lost certificates, or mundane and reasonable occurrences. NCANS *is* against the practice of offering a product for sale, taking investors' money, and refusing to deliver the product sold in anything approaching a prompt manner – i.e., failure to deliver as a trading strategy.

It is against this manipulative and predatory practice that NCANS has marshaled its efforts, and it is this destructive practice that we believe the SEC should eliminate from our market system.

How Much Fraud For Liquidity?

The SEC's concern with liquidity should not lead it to conclude that liquidity requires exempted delivery failures, and certainly not by having one market (derivatives) dependent on delivery failures in another market (equities). Aside from the obvious damage to investors and issuers unchecked delivery failures cause, the folly in this assumption can be demonstrated by studying foreign derivatives, options, futures and equities markets that all work harmoniously without permitting wholesale delivery failures in their equities markets. The Tokyo, Frankfurt, London, Australian and Euronext exchanges have strict delivery requirements in one form or another, across all their markets. This alone is compelling evidence that delivery failures are not necessary for the liquidity, efficient functioning, or competitiveness of market systems.

Exceptions to strict locate and delivery requirements in the equities markets are really just rank favoritism for one class of participant over all others. This is the definition of inequity, and of failing to protect investors so that some participants can enjoy more lucrative trading. NCANS believes that U.S. equity markets can provide sufficient liquidity without delivery failures, and further formally states that this inequity must be corrected or the integrity of the markets is compromised. Our position is that allowing delivery failures to accommodate market participant liquidity and business profitability concerns is <u>not</u> consistent with the protection of investors, or necessary or appropriate in the public interest – it is merely in the interest of the participants, who enjoy a resultant unfair advantage over investors.

Finally, NCANS believes that the basic functions of the securities markets should be structured in an automatically self-enforcing and self-correcting way, rarely requiring penalties or the intervention of the SEC.

For all of the above reasons, NCANS respectfully submits the following specific recommendations that go beyond the SEC's proposed amendments – in the interests of making the markets fair and safe for all participants, issuers and investors alike.

<u>Comments and Recommendations</u>

1. <u>*Proposed Amendment to Rule 203(b)(3)(i)- Elimination of the Grandfather Exception*</u>

Without the elimination of the grandfather clause, equity security investors will remain harmed indefinitely. The securities markets will also never be at a point of equilibrium, as determined by true demand/supply. Any market in a particular security with any amount of outstanding delivery failures will have the price artificially depressed as long as the grandfather exception is in place. Therefore, the grandfather exception in Reg SHO must be eliminated immediately. Nobody should be exempt, including the options market makers.

With the highly visible public discussion, notices, and implementation dates publicized in advance, 35 calendar days to close out the fails covered in the grandfather clause is more than sufficient notice.

Nobody forced market participants to create long-term delivery failures, and nobody profited more from the practice than the failing participants. If there are participants with open fail positions who refuse to deliver what they sold, relying on the grandfather exemption (in some cases for years) to shield them from delivery requirements, then there will be some financial hardship associated with abiding by delivery rules. That is unavoidable. However, the SEC didn't advise them to refuse to deliver; thus, it should not be the SEC's job to favor this delivery refusal with any further exceptions. Any financial discomfort arising from covering long term delivery failures is a necessary disincentive, if the markets are to have any sort of discipline. The grandfather clause rewards delivery failure by shielding those refusing to deliver securities from the natural financial consequences of their actions, creating an incentive for long term failure. This is not in the public interest, nor in the interest of investor protection.

In any case, market participants and the DTCC have stated repeatedly that delivery failures are a small problem. If this is true, then mandating the delivery of all grandfathered delivery failures and eliminating the exception from Reg SHO will only have a minimal impact; thus, volatility concerns shouldn't be an issue.

Eliminating long term delivery failures is a mandatory step in curbing abuse. Investors must have confidence that the pricing of securities represents legitimate supply and demand, without an artificial supply of undeliverable and non-existent securities or security entitlements having an undisclosed, unknown and wholly artificial depressive impact on their investments.

The first step in that direction is to close out old unsettled trades.

2. ***Proposed Amendment to Rule 203(b)(3)(ii) – Limiting the Options Market Maker Exception***

It is significant that the SEC now recognizes the harm that investors suffer at the hands of options market makers, when those market makers fail to deliver equity securities (at no cost to themselves) and then keep unsettled trades open indefinitely. This is not only a harmful practice, but a totally unnecessary one. In the derivatives markets, options market makers can make markets, provide liquidity, and hedge their options adequately without delivery failures in the equity markets. There is additional expense to do so, but why should equity investors underwrite that expense, as is the current practice?

Shortening the duration of the options market maker exception, as in the proposed amendment to Rule 203(b)(3)(ii), which requires close-out of delivery failures to the later of 13 consecutive settlement days from the date on which the security becomes a "threshold security," or the options position expires or is liquidated – is not enough.

As proposed, the market maker exception would not stop delivery failures from recurring, nor stop securities from becoming threshold securities, because options market makers could still continue delivery failures in *non-threshold* securities.

A working paper by the Wharton School at the University of Pennsylvania and the University of Northern Carolina (March 01, 2003), cited by the SEC, concludes that the options market maker exception likely creates significant profits for the market makers. As stated previously, this is a windfall for the derivatives markets and options market makers at the expense of equity security investors.

Naked short selling transfers the risk exposure and the hedging expense of the derivatives market makers onto the backs of equity investors, without any corresponding benefit to them. This is fundamentally unfair, and must stop. Options market makers must price in risk exposure without any free subsidies from equity securities investors. Derivatives market liquidity generated at the expense of equity investors is inequitable, and benefits only the participants; therefore, the options market maker exception *is not in the public interest* – as required for any exception, per Section 36 of the 1934 Act.

Options market makers, in the Susquehanna letter, have stated that they hedge in a "market-neutral" way. But the market makers are not limiting their liquidity to achieve a put/call balance in any security, so there is no guarantee of hedging neutrality in any particular security. In fact, the industry comment letter from the various exchanges states the opposite: *"In our experience, while most options market makers try to achieve a market neutral position by the end of each trading day, they may not be 'flat' in the sense of having no long or short positions or an equal number of long and short positions."*

It's precisely in the heavily-shorted securities and threshold securities that we see more put options than call options written and traded, and consequently more delivery failures by the options market makers. Equity market-neutral hedging can never be assured. In fact, this exception can be exploited to manipulate prices downward, by manipulators buying large numbers of put options in already heavily-shorted securities. There is nothing to prevent unscrupulous speculators from creating a spurious float of naked short shares via complicit options market makers, who are free to sell large numbers of put options, while offsetting the sale by buying call options from the speculator at favorable pricing; thereby de facto "renting" their exception to the speculator - selling him naked short shares to dump into the market, and pocketing the difference between the put price and the call price. NCANS believes that a number of the longtime SHO list securities are victimized by this practice.

As long as the exception from prompt delivery rules exists for options market makers, the derivatives markets will be a favored arena for market-manipulation-minded speculators to create specious liquidity via abuse of the exception.

<u>NCANS recommends the complete elimination of the market maker exception.</u>

For these reasons, NCANS is recommending the SEC eliminate the market maker exception in Rule 203 of Reg SHO <u>completely,</u> and require a <u>pre-borrow</u> on the part of **<u>all</u>** market makers and specialists.

<u>Effects of a pre-borrow requirement on options market makers</u>

The only negative consequences for the derivatives markets would be higher hedging expenses for options market makers, in the form of borrow fees. But this is to be expected when something goes from virtually free, to not free. The only thing that will change is that options costs will be more closely linked to actual supply of securities, predictably increasing costs for more scarce issues – as one would *expect* in a fair and equitable market. It is only due to the hidden subsidy provided at the expense of equity investors that liquidity and costs in SHO list securities options are artificially liberal. The increase in friction for the options market makers is merely the termination of the subsidy, and the cost absorbed where it belongs – with the market makers, and the options speculators.

NCANS believes that the increase in borrow fees would not be exorbitant, as most equity securities are not Reg SHO threshold securities, and so have plentiful availability to borrow at low cost. This means liquidity in put options and other derivatives should not see any significant impact in liquidity or pricing.

Options market makers are not expected to greet this idea with enthusiasm, just as any recipient of subsidies doesn't want to see their unfair advantage come to an end. While that is unfortunate for the highly lucrative options market making industry, NCANS sees no reason for equity investors to continue subsidizing this industry at equity investor expense. If writing options for equity securities with a scarce borrow isn't as lucrative a windfall business for the market makers, that is what a fair market looks like.

<u>Effects of a pre-borrow requirement on specialists and equity market makers</u>

Equity market makers and NYSE specialists have argued a need for exceptions to locate and delivery rules to maintain liquidity and market making activity. We disagree. Here again, we have one group benefiting at the expense of another. Liquidity in equities and market making would still function well without exceptions for these market participants, albeit not as outlandishly profitably.

One simple solution is to enter into contracts to pre-borrow, or reserve, securities from lenders who decrement their pool, and then borrow as-needed for short durations. This way, large blocks could be filled instantly and borrow fees would be limited, driven by fair supply and demand. But even without this, liquidity could be maintained, as there are always legitimate buyers and sellers – albeit at higher prices if demand exceeds supply. Again, that is a fair auction market at work. Bona fide market making typically involves buying and selling in a manner where delivery failures are short-term in duration. If a market maker is failing for long periods, that isn't bona fide market making – it's something else, and shouldn't be encouraged by allowing delivery failures in excess of what investors and other participants are allowed.

Under no circumstances should liquidity be created due to delivery failures extending past T +3. Market makers need to earn their money by filling large orders quickly with real securities, by finding buyers or sellers in legitimate ways (raising the price to where holders are willing to sell, or lowering the price to where buyers are willing to buy); not by artificially managing the price of securities for long intervals using delivery failures. That's not bona fide market making, although you will get no argument from NCANS that it is undeniably lucrative in the current regulatory environment.

<u>Specific consequences of eliminating the market maker exception</u>

1) <u>Reduce the negative impact on the price of securities</u>
   If options market makers are stopped from using delivery failures as a hedging strategy, and required to pre-borrow, the negative impact on the price of equity securities due to hedging put options would be limited. The downward pressure an options market maker could exert on security prices by hedging put options via delivery failures would be eliminated.

2) <u>Reduce downward manipulation schemes via the options market maker's delivery failures</u>
   Exerting downward pressure on the price of a security by manipulative speculators buying large numbers of inexpensive put options is a real danger for SHO list issues. There is abundant evidence in the put/call levels of SHO list companies to indicate manipulative exploitation of the options market maker exception, resulting in further downward pressure on the price of already-depressed securities. Whether via straightforward bulk buys of put options (exploiting the disconnect between actual supply of the underlying equity to hedge with and the pricing of the put options, due to the hidden equity investor subsidy) or via more elaborate arbitrage of put/call transactions (wherein the market maker pockets a fixed spread between the two options, and the speculator gets a supply of naked short shares to sell into the market), the clear intent is to depress the price of the underlying equity via the creation of artificial supply.

   Oftentimes, manipulators know they will make money from these schemes because they are buying put options to improve the profitability of their short positions, relying on the fact that the security will be short sold by the options market maker, regardless of the options market maker's ability to borrow or deliver; resulting in further price depression and creating windfall profits for the manipulators.

   The delivery failure exception for options market makers results in a system favoring the business interests of the options market makers and their more aggressively manipulative speculator clients over the interests of investors. It is an inequity that cannot stand in a fair and balanced market.

3) Increase borrow fees paid to securities owners
If the market maker exception is eliminated, market makers would be required to borrow securities, just like all other participants/investors wishing to make a short sale. This would create an opportunity for investors to receive compensation for lending their securities. The securities lending industry is growing by leaps and bounds, and its foundation is the concept of receiving pay for lending securities. If any parties, including options market makers, are permitted delivery failures as part of their business strategy, this undercuts not only the price of the securities, but also the right of securities owners to derive earnings from lending activity. Delivery failures disrupt market making in the securities lending industry, and deprives equity security owners of income by diluting the value of lending.

4) Stopping one group of investors from profiting at the expense of another
All risk exposure and hedging expense of options and derivatives would be paid by the market makers and derivatives markets speculators, and not by unsuspecting equity investors.

5) Increased price stability for equity securities
An added benefit would be greater price stability for equity securities, by eliminating oversupply due to delivery failures at the onset of options hedging, and then excess demand when the failed delivery positions are closed out. This seesaw volatility would be all but eliminated – especially important given the SEC's stated goal of reducing or eliminating volatility.

Additionally, the likelihood of any securities becoming threshold securities would be vastly reduced if all market makers were prohibited from engaging in delivery failures, and required to pre-borrow.

6) Maintain predictability for options market makers
The SEC granted the market maker exception in Rule 203 partly on the grounds that options market makers would have to assess the probability that a security could become a threshold security in the future, and thus be forced to unwind hedges previously opened, adding risk for the options market maker. The SEC quotes comments in a letter from Susquehanna.

However, this is only true if the hedges were created via delivery failures. If options market makers did not fail to deliver, but instead hedged via borrowed shares, this concern would vanish. Options market makers would never have to unwind hedges *prematurely* if they short sold with pre-borrowed securities for the duration of the options being hedged. Eliminating the options market maker's authority to naked short sell and instead requiring a pre-borrow would have the added benefit of reducing risk exposure, by making the hedging expense predictable and stable over the life of a particular option or trade. This eliminates the concern of having to unwind any hedges before the expiration of options due to a security becoming a threshold security. Bluntly, the market maker exception is *not necessary* on the grounds mentioned in the Susquehanna letter, as quoted by the SEC.

7) Strengthening the hedging and securities lending industry
Options market makers can hedge their risk exposure in several ways. The securities lending industry would be delighted to accommodate any securities borrowing needed by options market makers. Since most securities are not threshold securities, the majority of securities can be easily borrowed at relatively low cost. In hard-to-borrow securities, liquidity is there, so long as the borrower is willing to pay higher fees. That's how fair markets are made – scarcer commodities carry higher costs.

Further recommendations beyond the SEC's proposed amendments

1. Implement a universal delivery rule

The SEC cannot effectively deal with delivery failures by creating locate requirements. A market participant can locate all the securities in the world and still fail to deliver. The SEC must specifically address *delivery obligations*, as this is the root issue. Simply stated, locate requirements do not ensure delivery. The void left in the SEC's regulatory scheme relating to delivery rules must be rectified to be consistent with the 1934 Securities Exchange Act's requirement for *prompt delivery*. And it would be beneficial if the SEC codified the treatment of security entitlements to be consistent with U.C.C Article 8, wherein securities must be maintained on a one-for-one basis for security entitlements.

As previously discussed, the SEC was created via the 1934 Securities Exchange Act, which explicitly defines a securities transaction as one that effects a transfer of record ownership, and requires prompt settlement. U.C.C Article 8 also requires brokers to promptly obtain and maintain securities for any security entitlements they credit accounts. This is simplicity itself, and is basic to any transaction involving an exchange of cash for goods. Buyer pays, seller delivers. The 1934 Act concurs:

Section 17A of the 1934 Securities Exchange Act

> *The Congress finds that,*
>
> *The prompt and accurate clearance and settlement of securities transactions, including the transfer of record ownership and the safeguarding of securities and funds related thereto, are necessary for the protection of investors and persons facilitating transactions by and acting on behalf of investors.*

Section 17A of the 1934 Act leaves no room for delivery exceptions. Section 36 of the Act only allows the SEC to create exceptions, "*…to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors…*" We recommend that the SEC implement a universal delivery requirement in the Reg SHO amendment to comply with the Act, and put an end to delivery exceptions that are in conflict with investor protection.

This is no different from what the major security exchanges around the world already require and enforce. The LSE in London, Frankfurt Stock Exchange in Germany, Euronext across Europe, TSE in Japan, ASX in Australia…are just a few of the many exchanges across the world that function well with strict delivery requirements.

Any market participants that argue that strict delivery requirements are somehow dangerous to the markets, or liquidity, or investors, will have to explain how many large markets around the world manage just fine with strict delivery requirements, and buy-in requirements, and stringent penalties for delivery failures. As with many of the liquidity and exception arguments, these are really disguised appeals for preferential treatment for one class of market participants at the expense of others, using a "greater good" theory that is provably refuted by the aforementioned international examples.

The 1934 Securities Exchange Act, and the securities laws of practically all 50 States are aligned with current international exchange rules. There is no defensible reason for the U.S. equities markets to have delivery requirements that are riddled with exceptions. No good is served by that state of affairs, and considerable harm is created, damaging investors, issuers, and indeed, the integrity of the market system. Congress already came to that conclusion in 1934. We urge the SEC to abide by their wise counsel, and to implement a no-exception universal delivery requirement.

2. Implement a universal pre-borrow requirement for all short sales

Locate requirements should be just as simple and consistent as delivery requirements. NCANS recommends a universal pre-borrow to satisfy locate requirements for all short sales.

The borrow contract should always assure delivery in time to meet the delivery obligation of the executing short selling broker-dealer.

3. Implement a universal locate requirement

Along with the universal pre-borrow requirement for short sales, all other sales transactions must have properly located securities before the sale can be executed.

4. Implement buy-in and cancellation requirements

Currently, U.S. security equities markets do not assure investors they will receive rights to securities within the contracted time frame, nor are investors assured that they will receive all their money back when a trade fails. This is because the SEC has *failed to link clearing and settlement*, in violation of common sense, good business practices, and Section 17A of the 1934 Securities Exchange Act.

This is in stark contrast to foreign equity markets, and just about every other market in the world. It is also in stark contrast to the findings of Congress, and their direction to the SEC. Again, Section 17A of the 1934 Securities Exchange Act is explicit:

1934 Securities Exchange Act Section 17A

- *The Congress finds that--*

  A. *The prompt and accurate clearance and settlement of securities transactions, including the transfer of record ownership and the safeguarding of securities and funds related thereto, are necessary for the protection of investors and persons facilitating transactions by and acting on behalf of investors.*
  B. *Inefficient procedures for clearance and settlement impose unnecessary costs on investors and persons facilitating transactions by and acting on behalf of investors.*
  C. *New data processing and communications techniques create the opportunity for more efficient, effective, and safe procedures for clearance and settlement.*
  D. *The **linking** of all clearance and settlement facilities and the development of uniform standards and procedures for clearance and settlement will reduce unnecessary costs and increase the protection of investors and persons facilitating transactions by and acting on behalf of investors.*

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  A. *The Commission is directed, therefore, having due regard for the public interest, the protection of investors, the safeguarding of securities and funds, and maintenance of fair competition among brokers and dealers, clearing agencies, and transfer agents, to use its authority under this title--*
     i. *to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of transactions in securities (other than exempted securities); and*
     ii. *to facilitate the establishment of **linked** or coordinated facilities for clearance and settlement of transactions in securities, securities options, contracts of sale for future delivery and options thereon, and commodity options;* (emphasis added).

NCANS agrees with the findings of Congress as expressed in Section 17A of the 1934 Securities Exchange Act. It makes perfect sense. Clearance and settlement *must* be linked. A transaction can only be concluded once money and securities have traded hands, including transfer of record ownership. Straightforward, if the clearing and settlement occurred in a manner where clearance occurred concurrent with settlement; i.e., funds were only debited from the buyer's account and transferred to the seller when good form delivery took place, including the stipulated transfer of record ownership. But that's not what happens in our current system. Clearance and settlement are not linked, and funds are transferred before any securities have been delivered and transferred to the buyer. Given that current DTCC and SEC rules and policy are the polar opposite to 17A's requirements, it is necessary to construct a mechanism to deal with delivery failures absent the obvious "linked" incentive envisioned by Congress that you have to deliver to get paid. The SEC, in its wisdom, has approved rules that remove this simple mechanism, and allows transfer of funds absent any delivery, and even crediting of the difference between the current mark-to-market value of the security and the sale price to the failing seller's account (to be used as he sees fit); thus, a new mechanism is required, albeit a far less effective one.

Part of the problem arises from Wall Street's need for speed in processing transactions, and in the systems created to achieve requisite efficiencies. The Continuous Net Settlement (CNS) system, introduced in October 1974, is a de facto removal of the linkage that the 1934 Act mandates between clearance and settlement. In CNS, funds move back and forth, but ownership does not; which creates the sort of de-linked transaction that harms investors rather than protecting them – they are denied the use of funds, their accounts are debited, and yet no delivery has taken place; and in some cases, delivery may never take place. Given that the SEC has seen fit to de-link clearance and settlement, in violation of 17A's requirement for linkage, the least it can do is ensure that there is a mandatory mechanism for dealing with delivery failures. To date, there is none. The DTCC claims to be powerless to effect buy-in of failed deliveries, and the SEC goes along with this position; ignoring that the DTCC is chartered with policing the business conduct of its owner/participants, including ensuring they comply with all securities laws. So nobody in the regulatory framework will enforce buy-ins, which is the only mechanism that can serve as an effective disincentive for allowing delivery failure (barring waiting for delivery to pay the seller). This cannot continue.

Further examination of the conflict between 17A's requirement for linkage and the SEC's rulemaking is a topic beyond the scope of this document. However, it does give rise to an important question: what to do in this de-linked environment when securities fail to be delivered? The obvious answer is to buy-in the failed transaction; and if no satisfaction is achieved, break the trade.

Accordingly, this de-linked environment must include a formal rule for dealing with delivery failures beyond T+3, which should impose a buy-in authority and requirement on the part of the clearing and settling agents, and the additional authority and requirement to cancel trades should a prompt buy-in prove impossible.

<u>Buy-in procedure</u>
NCANS recommends that all clearing agents be authorized and required to buy-in delivery failures, commencing no later than T+5.

<u>Cancellation of trade</u>
Should a buy-in result in another delivery failure, the trade should be cancelled at T+9 by the clearing agent and all money returned to the investor, with worst case pricing in favor of the investor. Should the price be lower at T+5, the investor would receive back all his original investment money. If the price of the security is higher at T+5, then the investor would receive

the proceeds as if he had sold the securities at the higher closing price, with the difference debited from the seller's account.

The buy-in should only be attempted once before cancellation is required.

Removal of market maker from offer
The SEC must clearly define the process of a buy-in and the responsibilities of the market makers during a period of buy-ins. Fails exceeding T+5 should be closed out immediately through the process of a "Guaranteed Delivery" buy-in. Market makers representing the offer must remove themselves from the offer position if they do not represent shares available for guaranteed delivery. Buy-ins cannot be confronted with delays due to the market makers representing non-available shares. The priority must be on past trade executions and not on how a market maker wishes to represent a market. Market makers responsible for buying-in house account FTDs must be removed from "the box" to insure that they are not controlling the price of the security in order to receive a preferred buy-in cost.

5. Security Entitlements

Since the SEC permits broker-dealers to credit security entitlements to investor accounts in place of genuine securities, and since security entitlements are used by practically all brokers to represent real securities, the regulation of security entitlements is just as important as the regulation of securities. NCANS agrees that the use of security entitlements is a practical and a logical policy. However, the SEC should promulgate clear rules governing their use. Currently, there is much opportunity for abuse, as regulation and enforcement are lacking.

Without closely monitoring and regulating security entitlements, and in particular requiring that security entitlements be credited and treated in the same way securities are treated, any security regulation will be easily circumvented. A parallel universe of trading and abuse can occur, simply by broker-dealers crediting security entitlements in accounts in a way that differs from securities regulations for actual securities. The rules encompassing security entitlements must mirror those encompassing securities.

The SEC needs to be clear that security entitlements are to be treated as if they were securities. Every security entitlement credited to an account must have a bona fide security to support it, on a one-for-one basis, at all times.

The absence of a system to cross-reference how security entitlements are treated in relation to the securities underlying them creates an area of abuse the size of the entire securities market.

One example of apparent rampant abuse is in the data obtained by Dr. Patrick Byrne of Overstock.com, wherein prime brokers credited 10.3 Million security entitlements to accounts, but only maintained 3.6 Million securities at the DTC - failing to obtain millions of securities for their clients. Another example also involves Dr. Byrne; specifically, when he purchased 150,000 shares of OSTK in the open market, demanded proof of delivery, and failed to receive delivery for over 60 days – with his broker explaining that Overstock shares were "hot" and it was thus hard to obtain genuine Overstock securities; and that attempting a buy-in would be pointless, as it would only create more failed trades. A striking example involves Global Links, whose Freedom Of Information Act (FOIA) data revealed 27 Million delivery failures for a company with 1.1 Million issued securities – 25 times the legally issued securities were security entitlements with no underlying securities, and no legitimate expectation of delivery. Other examples include the many cases where investors are unable to obtain physical certificates for their securities for extended periods – sometimes, for years.

In many cases, any buy-in or covering of short positions in affected companies only results in further delivery failures. The first step to ending this self-sustaining delivery failure cycle is to eliminate any further crediting of security entitlements that lack securities to support them.

NCANS believes the current unregulated parallel market resulting from the misuse of security entitlements short-circuits securities regulations.

Corporate governance is compromised when security entitlements are credited to accounts in greater numbers than the number of outstanding securities authorized by issuers. The most glaring example of this is in corporate voting, where over-voting is literally ubiquitous in the equity securities markets.

Frank Partnoy, law professor at the University of San Diego, writes*: "It might seem incredible, but shareholder voting in developed countries is more tainted than voting in undeveloped ones. Some shareholders' votes are counted, others are not. Many investors are permitted to vote, even though they have no such right."* He further points out one instance where a bank was fined for submitting 8.5 million proxies, when the bank only owned 4.2 million securities.

The Securities Transfer Association has also reported widespread over-voting and tabulation problems during shareholder votes, and ADP has an algorithm that "adjusts" vote counts by *throwing out votes*, making a mockery of shareholder votes and corporate governance.

In addition, the issuer is the only one authorized to issue securities – and thus, to control supply. Removing this control from issuers, and allowing broker-dealers to create supply literally out of thin air to meet virtually any demand, completely destroys the integrity of an auction market, and eliminates any expectation of a connection between price, supply and demand.

Broker-dealers create excess and unauthorized supply by crediting security entitlements in accounts without obtaining securities. They will typically do this in a practice called "desking the trade," whereby the investor's buy order is satisfied internally by the broker-dealer, and no buy order is executed in the market. The broker-dealer is the "contra-party" in the trade, acting as the seller to its client/buyer. Technically, these trades stay out of the clearing system, and don't have to go through the DTCC.

Investor accounts are debited the full purchase price of the securities, but receive none of the rights of genuine securities, since no securities were obtained – the investor receives a security entitlement with no corresponding security to back it up.

NCANS believes that when a broker-dealer credits a security entitlement to an account, that the broker-dealer has an obligation to obtain the security being represented by the security entitlement within 3 days.

The only way to ensure that security entitlements are being credited correctly and in accordance with securities laws is to link all security entitlements with all securities in all broker-dealer depositories (such as the DTC) on a daily basis. Only by linking the two can a control be established.

NCANS Recommendations

Security entitlements need to be marked in one of three ways

NCANS is proposing an automated audit system to compare security positions with credited security entitlements, and to automatically mark security entitlements in one of three different ways:

1. **Bona fide** security entitlement, with entitlement to genuine securities actually obtained and held by the broker-dealer for credit to the client's account. These need not be marked in any special way.

2. **Failed "F"** security entitlement, with a security delivery failure - i.e., a security entitlement that never had a security delivered to support it. An "F" should appear next to the ticker symbol in accounts to indicate that there is a violation of delivery or maintenance rules for the underlying security. It can be due to a delivery failure, or a violation of the securities maintenance requirements of SEC rule 15c3-3.

   At some point, security entitlements require delivery of securities, so the SEC should define when security entitlements have failed. NCANS recommends that Reg SHO's locate and delivery requirements for securities also apply to security entitlements, with delivery of securities to support the entitlements no later than 3 days following the transaction date (T+3). Any security entitlements that have no underlying securities 3 days after being credited should be considered *failed security entitlements*, and should be bought-in.

   Any security entitlements that are in non-lendable accounts but are found to have their securities illegally lent out or otherwise violating 15c3-3, should also be considered failed, marked "F," and be bought-in.

3. **Bona fide "L"** security entitlement, with temporarily lent out securities. These are security entitlements that have had the underlying securities lent out, and are in compliance with 15c3-3. These should be marked with the "L" designator so as to be easily differentiated.

All three need to be clearly distinguished in book-entry form in accounts, and the numbers of each made available to the marketplace. Computerized entry makes this a snap.

Securities linked to security entitlements

The only way to ensure that security entitlements are not used to misrepresent real securities is to link and compare the number of all security entitlements each broker has credited to accounts with the number of bona fide securities each broker-dealer owns, or has on deposit at a depository. Under no circumstances should the number of security entitlements exceed the number of bona fide securities.

NCANS recommends that this daily audit be conducted in an automated manner after the market close, and be administered by a clearing agency or the SRO. A daily discrepancy report for each broker should be compiled, comparing the number of all T+3 credited security entitlements with the number of securities each broker owns. Any discrepancies should be automatically reported and published and a buy-in for any required securities initiated.

Numbered securities corresponding to security entitlements

Each security should have its own, unique number, much as each currency note does, or each car. Security entitlements should be linked to specific securities, and should have corresponding numbers to identify the specific securities that support them. In today's automated age, there is no reason that this cannot be a standard.

Daily automated audit system

The automated audit system being proposed should compare the following positions and report and publish discrepancies on a daily basis after market close:

1. Determine the aggregate number of T+3 security entitlements credited by individual broker-dealers to accounts;
2. Determine the aggregate number of securities owned in all depositories by individual broker-dealers;
3. By comparing the numbers of 1 and 2, any number of T+3 security entitlements that exceed the number of securities owned should be determined to be either "L" or "F" by the audit system;
4. Any "F" market security entitlements should be bought in.

Buy-in for security entitlement fails

The administrator of the automated audit system should be required to buy-in securities to eliminate excess security entitlements commencing T+4, and no later than T+5. Should a buy-in result in a delivery failure, the security entitlement should be cancelled at T+9 by the administrator and all money returned to the investor, with worst-case pricing in favor of the investor. Should the price be lower at T+5, the investor would receive back all his original investment. If the price of the security is higher at T+5, then the investor would receive the proceeds as if he'd sold the securities at the higher price.

Compliance with SEC rule 15c3-3

Any security entitlements found to violate SEC rule 15c3-3 are to be marked "F" by the automated system and have their missing securities bought-in.

Delivery of physical security certificates within 15 days

The current, arbitrary delivery timeline for physical security certificates makes a mockery of property rights, with brokers arbitrarily delaying delivery of physical certificates for weeks, or months, or years at a time. NCANS believes that long delivery timelines are articulated to dissuade investors from obtaining certificates, as often the brokers' interests are adversarial to their clients', as they never secured genuine securities to back up the security entitlements they represented to their clients as bona fide. Thus, the longer the delay, the more time the broker has to obfuscate the failed nature of the security entitlement, and to purchase securities at pricing favorable to the broker. This is inherently adverse to the 1934 Act mandate of investor protection, and must stop.

Should investors demand physical certificates for their securities, the broker-dealer should deliver them no later than 15 days from the request date, or face penalties for delivery failure. These penalties should be 1% of the current aggregate value of the certificates on the day they are due. There have been too many cases where investors were unable to obtain delivery of securities in certificate form. The aforementioned Dr. Byrne/Overstock.com revelations illustrate how uncontrolled creation of security entitlements can damage market integrity for a security. In all the cases, broker-dealers issued more security entitlements than the company had issued securities, thus making it impossible for broker-dealers to deliver certificates to all investors for all the securities investors believed they had purchased. This is the definition of a derailment in the securities industry. In the past, broker-dealers paid no penalty when exposed in this manner. A prompt delivery requirement, with penalties for delivery failure, are essential for investor and issuer protection.

Pre-locate rule for security entitlements

Almost identical to the requirements for sales and short sales, a broker-dealer must first locate real securities that can be delivered within 3 days before crediting security entitlements to accounts. Delivery obligations from clearing agents and market makers would satisfy the locate requirement, so as to allow the immediate crediting of security entitlements to accounts.

Delivery rule for security entitlements

Identical to the requirements for sales and short sales, a broker-dealer should be obligated to obtain securities within 3 days of crediting security entitlements. This can be either by purchasing or borrowing the securities. If there is a failure, either a buy-in or cancellation should be required, just as for all securities transfers.

Security entitlements and the securities lending industry

When securities are borrowed from investor accounts, the security entitlements in the accounts need to reflect the loan and the resultant elimination of the account holder's rights, since a security entitlement with the underlying security loaned out does not have the rights associated with a genuine security; including voting rights, the right to preferential tax treatment of dividends, and share dividend rights. We believe that this transparency will not impede or harm the securities lending industry, but that investor protection requires informing account holders of the accurate status of their security entitlements at all times -- including differentiating failed security entitlements from bona fide security entitlements with lent securities.

Broker-dealers have an obligation to promptly deliver securities to purchasers. All securities laws, including Reg SHO's locate and delivery requirements, should also apply to security entitlements. If meaningful market regulation is to be achieved, an unregulated market in security entitlements must be avoided. This can only be accomplished by promulgating rules that formally link security entitlements with bona fide securities, and by creating an automated audit/verification mechanism for security entitlements that mandates enforcement via buy-ins.

6. Limit total short interest

Some securities have a short interest in excess of 100% of authorized outstanding tradable securities. This can only mean that securities are being lent out multiple times, for multiple short sales. In Australia, the short interest in any security is limited to 10% of issued securities. NCANS believes that any short interest in the U.S. markets should be limited to 50% of issued securities. Otherwise, the basic equilibrium of supply and demand is destroyed, as is pricing integrity. And the return of borrowed securities is jeopardized, resulting in potentially massive volatility should a majority of lent shares be called back – again, diminishing investor protection and creating dangerous disequilibrium for the markets.

NCANS recommends that once the daily short interest reaches the 50% threshold, all short sales in the security should be suspended until the number falls below the threshold.

7. Publish short interest, delivery failure and excess security entitlements data daily

Transparency in securities markets is an essential to continued investor faith in the integrity of those markets. Substituting speculation, innuendo, rumors, or assumptions in place of hard market data can result in grave investment errors, damaging investor protection and endangering the formation of capital. U.S. securities markets must compete with international markets in their disclosure of important data, and become as transparent as their international counterparts. No good is served by creating opacity, and failing to disclose material data about important metrics like short interest or failed deliveries assists market manipulators to the detriment of investors and honest participants.

Participants have long been pro-secrecy and anti-transparency, as it affords them an edge over investors. Wall Street's efforts to limit the amount of disclosure to investors of participant behavior is nothing new. In the Pecora hearings, which resulted in the drafting and passage of the 1934 Securities Exchange Act and the creation of the SEC, Wall Street's most venerated names opposed any and all disclosure or regulation. Ferdinand Pecora, in his memoirs, wrote:

"Bitterly hostile was Wall Street to the enactment of the regulatory legislation."

As to disclosure, Pecora had this to say:

"Had there been full disclosure of what was being done in furtherance of these schemes, they could not long have survived the fierce light of publicity and criticism. Legal chicanery and pitch darkness were the banker's stoutest allies."

Then, as now, opacity is the ally of larceny. For our market system to be fair and honest, transparency is mandatory.

We recommend that the following be published daily:

a) Short interest in every security
b) The number of delivery failures in every security
c) The number of failed security entitlements in every security
d) Any short position that is greater than 5% of the company's issued and outstanding shares – exactly the same as with 5% or greater long positions.

This would allow investors and market participants to make better investment decisions, thereby increasing market efficiency and investor protection. Secrecy is the antithesis of fair and full disclosure, and has no place in the modern securities markets of the most powerful nation on the planet.

8. <u>Proposals on securities lending via the Stock Borrow Program</u>

<u>Maximum loan period</u>
NCANS believes that a time limitation on the duration of a loan from the Stock Borrow Program (SBP) should be imposed, with a mandatory return of the security at the conclusion of the loan period - no more than T+10 days. The current scheme, wherein a loan from the SBP can remain open in perpetuity, is antipodal to the stated short-term curative intent of the program.

<u>Compliance verification with 15c3-3</u>
Cash and retirement account securities are not differentiated at the NSCC in the fungible pool used for the SBP. Participants are trusted, on the honor system, to exclude them from being deposited into the lending pool at the SBP - which they are mandated to do by SEC Rule 15c3-3. The problem is that no mechanism exists for ensuring that participants are actually doing so, and that they are only making marginable securities available via that program. It is of critical

importance that the SBP lending pool be exclusively composed of legitimately lendable securities, and that participants are not allowed to use investor-owned assets (in cash and retirement accounts) to generate revenue via the SBP, and to shore up their capital requirements. The SEC must mandate clear differentiation and marking of lendable versus unlendable securities at the DTC/NSCC level; and further, create a policing and enforcement mechanism to prevent abuse. At present, there is no such mechanism. This invites larceny. Verification of compliance with 15c3-3 must occur at the SBP level. An honor system without a verification/enforcement system is not an adequate safeguard against abuse. Prohibitions are fine; however, the SEC needs to require that its SROs institute a preventive mechanism to keep cash and retirement account securities from being deposited into the SBP. NCANS believes that a spot audit of participant accounts for compliance is the most obvious way to ensure 15c3-3 is being observed.

Limitation on short interest

The SBP, like all other security lending facilitators and lending pools, allows serial re-lending of the same securities by allowing participants to re-deposit securities back into the SBP or the lending pool they originated from, for lending again. The recipient of an SBP-lent security is able to re-deposit the security back into the SBP, for SBP re-lending to cure another delivery failure. This allows a security to be re-lent an unlimited number of times from these self-replenishing pools, potentially creating an unlimited number of security entitlements in investor accounts. A cap on total short interest would stop this from continuing in perpetuity, as no further SBP-lent shares would be available once the short interest threshold was hit.

It is beyond the scope of this proposal to go into an in-depth analysis of the SBP and the manner in which it can be, and is being, abused by participants. These three proposals, along with the Security Entitlements proposals, would effectively end any abuse, and return the SBP to a lending mechanism that cures only short-term, legitimate delivery failures. It is not in the public interest, nor does it protect investors, to have lending via the SBP for unlimited durations, with no policing to ensure 15c3-3 compliance, and with no cap on amount.

Conclusion

The available numbers are staggering. NYSE and NASDAQ outstanding delivery failures (FTDs) represent 4% of average daily trade volume; and OTC outstanding delivery failures represent 28% of average daily trade volume - and on some days, 100%. These figures are only for failed security deliveries, and do not include “ex-clearing” delivery failures and their resultant failed security entitlements.

When FOIA data reveals that on some days 40% of the daily trading in NovaStar Financial (NFI) (a profitable, billion dollar market cap company, and one of the longest-tenured SHO-list regulars) results in delivery failures, then no company or security is safe. This kind of liquidity is not desirable; and in fact, represents a clearly dangerous artificial supply, resulting in long term price depression. Contrary to the sentiment of an industry that is paid by transaction volume, not all liquidity is good. Liquidity driven by delivery failure is nothing but institutionalized fraud against investors who believe they are buying bona fide securities.

With the pension reform bill recently passed by Congress, even more 401k participants will be enrolled and invested in the securities markets. As previously stated, the responsibility of the SEC is to ensure their, and indeed all investors', protection. Our philosophy is that if the smallest investor is protected, then by default the largest institutions are protected.

The fail-to-deliver issue is not a trivial problem that can be solved by tweaking the rules a bit. While the manner in which the scope of the problem is described by the DTCC and the SEC is designed to minimize its perceived severity, the reality is that the structural deficiencies in the regulatory scheme that have created situations like the massive over-voting problem are the same as those that have enabled long term delivery failures. A litany of exceptions, and waivers, and non-penalties, and vague rulemaking language have created a monster wherein nobody can be sure what they are buying when they purchase an issuer's security. That destroys market integrity, is adverse to the public's interests, and renders investor protection impossible.

This problem requires extensive, simultaneous reform. The proposed amendments, and NCANS' recommendations, can be easily circumvented if the SEC fails to *concurrently* address all areas where delivery failures occur. That is why our recommendations are comprehensive. Otherwise, delivery failures will continue unabated, and those wishing to avoid delivery will do so by simply migrating to areas left unaddressed by the SEC.

We believe that the recommendations set forth in this comment letter would not only eliminate deliberate delivery failures, but would enable the markets to self-regulate by creating a regulatory framework wherein delivery failures couldn't persevere for long, and where the financial incentives to deliver are aligned with the SEC's mandates. The improved reporting would afford far greater market transparency, allowing for the more efficient allocation of capital and more comprehensive investor protection. And the U.S. markets would again be competitive with international alternatives, ensuring the long term viability of the system, its participants, and issuers.

In closing, it is worth again revisiting the latitude afforded the SEC for making exemptions to the Securities Act of 1933, and the 1934 Securities Exchange Act. This exemption power lies within Section 36 of the Securities Exchange Act, where exemptions are permitted "*…to the extent that such exemption is <u>necessary or appropriate in the public interest</u>, and <u>is consistent with the protection of investors</u>…*" (emphasis added). NCANS takes the position that allowing one class of participant to profit at the expense of investors is not consistent with the protection of investors. We also take the position that exempting any group from Section 17A's requirement for *"...prompt and accurate clearance and settlement of securities transactions, including the transfer of record ownership and the safeguarding of securities and funds related thereto…"* is not consistent with the protection of investors. Allowing securities entitlements to remain unregulated, and thus rife with abuse is not consistent with the protection of investors. Exempting participants from facing buy-ins when they fail to deliver is not consistent with the protection of investors. Allowing participants to use a "locate" premise as their exception to borrowing and delivering what they sell is not consistent with the protection of investors. In short, many of the exemptions afforded to some classes of participants are not necessary or appropriate in the public interest, and are not consistent with the protection of investors. The SEC would be well advised to consider those requirements that limit its exemption capability, and review its rules and regulations for consistency with those requirements.

NCANS members believe that the future prosperity of this country lies in the SEC acting decisively, correcting the noted structural deficiencies, and creating a genuine, trustworthy engine of economic vitality. We are hopeful that the SEC recognizes the opportunity that presents itself in focusing on the delivery failure issue; and further, has the fortitude and the vision to make the necessary changes, and correct the problem once and for all.

NCANS appreciates the chance to offer comments on the Regulation SHO amendment proposal. If we can be of further service to the Commission or its staff in their evaluation of these matters, please let us know.

Respectfully submitted,

NCANS

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