TESTIMONY BEFORE THE

MISSOURI STATE SENATE

INTERIM COMMITTEE ON CONSUMER AND FINANCIAL PROTECTION

"EXAMINING THE ISSUES OF NAKED SHORT SELLING"

OCTOBER 15, 2007

I. INTRODUCTION

A. Background on SIFMA

The Securities Industry and Financial Markets Association ("SIFMA") brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. SIFMA's activities include educational outreach to and representation before the U.S. Congress, the Securities and Exchange Commission ("SEC"), Commodity Futures Trading Commission ("CFTC"), Federal Reserve Board, U.S. Department of the Treasury, state legislatures, and international regulatory agencies. SIFMA also participates in a number of private sector initiatives, including, among other things, development of industry sound practices and standard industry documentation, and sponsoring conferences highlighting regulatory developments.

On behalf of its membership, SIFMA is pleased to provide this testimony to the Missouri State Senate, Interim Committee on Consumer and Financial Protection, which is examining the issue of so called "naked" short selling.

B. Background on Short Selling

The terms "short selling" or "shorting" generally refer to transactions whereby a person sells securities that he does not own. The "short" seller commonly arranges to borrow securities from his or her brokerage firm, which will deliver the securities to consummate the transaction. The short seller later closes out his or her short position by purchasing equivalent securities, in order to return the borrowed securities to his brokerage firm or other stock lender. If the price of the stock declines after the short sale, the short seller is able to buy the stock back at a lower price and profit from the difference between the sale price and the subsequent purchase price. If the price of the stock rises, the short seller may incur a loss.

II. BENEFICIAL ROLE OF SHORT SELLING IN CAPITAL MARKETS

While the concept of selling a stock that one does not own may, at first blush, seem peculiar or even suspicious to many people, short selling is in fact a longstanding, legitimate practice that provides numerous benefits to the market, including:
(i) countering unwarranted, speculative upward price pressure in stocks, and even uncovering and exposing fraudulent issuer activities; (ii) enabling a person to hedge the risk of a stock position owned, and thereby protect against a price decline; (iii) providing liquidity in response to buyer demand; (iv) providing latent buying interest; and

(v) facilitating efficient markets. The SEC has succinctly recognized the value provided by short selling, noting that:

> [s]hort selling provides the market with at least two important benefits: market liquidity and pricing efficiency. Market liquidity is generally provided through short selling by market professionals…who offset temporary imbalances in the buying and selling interest for securities. Short sales effected in the market add to the selling interest of stock available to purchasers and reduce the risk that the price paid by investors is artificially high because of a temporary contraction of selling interest. Short sellers covering their sales also may add to the buying interest of stock available to sellers…Short selling also can contribute to the pricing efficiency of the equities markets. Efficient markets require that prices fully reflect all buy and sell interest. When a short seller speculates or hedges against a downward movement in a security, his transaction is a mirror image of the person who purchases the security based upon speculation that the security's price will rise or to hedge against such an increase. Both the purchaser and short seller hope to profit, or hedge against loss, by buying the security at one price and selling at a higher price. The strategies primarily differ in the sequence of transactions. Market participants who believe a stock is overvalued may engage in short sales in an attempt to profit from a perceived divergence of prices from true economic values. Such short sellers add to stock pricing efficiency because their transactions inform the market of their evaluation of future stock price performance. This evaluation is reflected in the resulting market price of the security.[1]

In periods of bear markets, as has been true from time to time recently, the topic of short selling becomes controversial, particularly among those who have an interest in seeing market prices rise. Critics of short selling practices often claim that short-sellers unfairly collude to drive down stock prices, but academic research has not linked market declines to any single trading strategy or concluded that short selling drives prices to levels they would not otherwise reach on the basis of issuer fundamentals or other, exogenous factors.

The fact is that short sellers, by expressing negative views on particular stocks, tend to dampen what may be irrationally positive market perceptions. They contribute to liquidity and to price formation, which are fundamental to market efficiency and to free-market pricing of assets. Those whose investments lose value when prices decline are

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[1] Securities Exchange Act Release No. 48709 (October 28, 2003), 68 FR 62972, 62972 (November 6, 2003).

counterbalanced by those who can buy at the reduced prices and whose buying pressure tends to restore market equilibrium. Furthermore, short sellers can serve a public policy role by researching and identifying companies whose financial condition and/or accounting practices, may be flawed or even outright fraudulent. Through their investigatory research, short sellers have often acted as "whistleblowers" regarding such fraudulent companies, exposing them to the light of day and subsequent criminal and civil fraud actions. In this manner, short sellers identify and stigmatize the bad actors, many of whom, like the former Chairman of Enron Corporation, try and blame the "shorts" as the source of their downfall, a myth that was exploded in his criminal trial:

> The trial underscores that neither defendant fully accepted what happened at the company. Mr. Lay testified that the collapse was largely caused by short sellers, critical articles in The Wall Street Journal, and a resulting panic in the marketplace.
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> But short selling, negative press and market concerns are issues that scores of companies deal with every year, without collapsing. Indeed, to some degree, Mr. Lay's argument was a bit like blaming a match for igniting a basement filled with gasoline. In this case, the accelerant was the poor condition of Enron's financial structure.[2]

Research conducted by academic economists generally tends to confirm that short selling contributes to the health of the markets and that the companies that complain most bitterly about short selling are often the companies most in need of governmental investigation and possibly prosecution:

> The evidence on subsequent stock returns suggests that in public battles between short sellers and firms, short sellers usually are vindicated by subsequent events. The evidence suggests that short sellers play an important role in detecting not just overpricing, but also fraud. Policy makers might want to consider making the institutional and legal environment less hostile to short sellers.[3]

SIFMA feels strongly that short selling is not only a legitimate investment activity, but one that plays an important role in improving market efficiency and price

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[2] Kurt Eichenwald, "In Enron Case, a Verdict on an Era," N.Y. Times, May 26, 2006, available at: http://www.nytimes.com/2006/05/26/business/businessspecial3/26verdict.html?ei=5088&en=a9fee664060b30ea&ex=1306296000&partner=rssnyt&emc=rss&pagewanted=all.

[3] Owen A. Lamont, Associate Professor of Finance at the Graduate School of Business, University of Chicago, commenting on the data in his study of battles between short sellers and firms entitled, "Go down fighting: Short sellers vs. firms."

discovery. By allowing market participants to place short positions on particular securities that they believe to be over-valued, the existing regulatory scheme allows investors not only to protect their own investment portfolios, but also to reduce market volatility and help bring asset valuations back into line. Indeed, short-selling may serve as an important counter-balance to "bubble" markets and the long biases of other market participants. As famed market expert Edward Chancellor wrote in 2001, "we need more, not less, shorting activity if, in the future, we are to avoid wasteful bubbles, such as the recent technology, media and telecoms boom."[4]

III. NAKED SHORT SELLING

One kind of short selling, namely, so-called "naked short selling," is the focus of much issuer and media attention. This term generally refers to instances where a short seller does not arrange to borrow securities necessary to complete the sale transaction. In some instances a naked short seller is unable or unwilling to obtain the securities sold and thus cannot deliver them to the buyer. This may result in a trade failing to "settle," a term which refers to the completion of a transaction, whereby the funds and securities are exchanged between the buyer and seller's brokers (*i.e.*, the contracting parties) through a "clearing agency" which is registered with the SEC. Transactions that do not settle within the normal 3 business day settlement cycle are typically referred to as "fails-to-deliver" or "fails."

As the SEC staff has specifically noted, not every fail-to-deliver is caused by naked short selling and, furthermore, fails-to-deliver are not per se manipulative, and may not even be improper or illegal:

> Failures to deliver may result from either a short or a long sale. There may be legitimate reasons for a failure to deliver. For example, human or mechanical errors or processing delays can result from transferring securities in physical certificate rather than book-entry form, thus causing a failure to deliver on a long sale within the normal three-day settlement period.[5]

Furthermore, it is important to understand that the vast majority of clearance and settlement of securities transactions occurs through the continuous net settlement system ("CNS"), operated through the National Securities Clearing Corporation ("NSCC"), a "clearing agency" that is registered with, and subject to oversight by, the SEC. In short, CNS is an automated book-entry accounting system that centralizes the settlement of compared security transactions and maintains an orderly flow of security and money

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[4] Edward Chancellor, "A Short History of the Bear," Guest Analysis, http://www.prudentbear.com/press_room_short_selling_history.html (October 29, 2001).

[5] SEC, *Division of Market Regulation: Key Points About Regulation SHO* (April 11, 2005).

balances. More specifically, CNS essentially nets all settling purchase and sale transactions (long and short) in particular securities effected by a "clearing firm participant." These transactions are netted against each other and netted against the prior day's closing positions (if any) to compute the participant broker-dealer's net settlement commitment (CNS position) each day. To effect settlement of a participant broker-dealer's CNS delivery obligation, existing securities positions are transferred from such participant's account at the Depository Trust Company ("DTC") to NSCC's account to cover the participant broker-dealer's delivery obligation to CNS.

The development and implementation of CNS has provided the securities industry with a number of efficiencies, as well as reduced risks. These include the following:

- Regardless of volume, CNS nets on a daily basis participants' security obligations to one net long or short position in each issue, thereby minimizing security movements and associated costs – this action is crucial to avoiding the type of crisis in the clearance and settlement of securities transactions as was experienced in the late 1960's and early 1970's (often referred to as the "paper work crisis"), in which firms were unable to process a rising volume of trades, thereby causing a domino effect of failed settlements of securities transactions among brokerage firms.
- Through CNS, NSCC becomes the contra-party to each compared trade and guarantees settlement.
- Closing fail positions are marked-to-market daily, which reduces risk and ensures the integrity of the system.

The operation of CNS has been further described by the SEC as follows:

> Under [CNS], NSCC becomes the contra-party to each purchase or sale of securities. NSCC assumes the obligation of each member that is receiving securities to receive and pay for those securities, and it assumes the obligation of each member that is delivering securities to make the delivery. NSCC is also assigned the receiving party's right to receive securities and the delivering party's right to receive payment. The assumption of these obligations and the assignment of these rights place NSCC between the delivering member and the receiving member – the delivering member is obligated to deliver securities to NSCC; the receiving member is obligated to pay for securities delivered by NSCC; and NSCC is obligated to receive and pay for securities

> from the delivering member, and to deliver securities to the receiving member.[6]

A broker-dealer that fails-to-receive securities may either maintain that position and wait for delivery to be made as securities are delivered to NSCC, or it may file a Notice of Intent to Buy-In with NSCC. In response to the filing of such notice, NSCC takes a series of steps to facilitate the buy-in including, if necessary, executing a buy-in in the market, with any losses incurred in connection with such purchase being allocated in accordance with NSCC procedures to members that have fail-to-deliver positions in the security.

Although some commenters allege that fails-to-deliver result in the purchaser of the securities paying for shares, but never receiving them (*i.e.*, there are allegations made that these are "phantom shares"), it is important to note that such an assertion is simply not accurate. Rather, as has been specifically stated by the SEC:

> The fact that a broker-dealer that is an NSCC member fails to receive securities that it purchased on behalf of a retail customer does not mean that the customer's purchase is not completed until the member's failure to receive is cured. Under Article 8 of the Uniform Commercial Code, a securities broker may credit a customer's account with a security even though that security has not yet been delivered to the broker-dealer's account by NSCC. In that event, the customer receives what is defined under the Uniform Commercial Code as a "securities entitlement," which requires the broker-dealer to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the security.[7]

The customer thereby has full ownership of the security purchased, and is able to re-sell the position at his/her discretion, thus enabling the customer to profit if the security's price has increased.

It is equally important to note that naked short selling can have many meanings, and is not necessarily manipulative or violative. As the SEC has specifically noted:

> Naked short selling is not necessarily a violation of the federal securities laws or the Commission's rules. Indeed, in certain circumstances, naked short selling contributes to market liquidity.

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[6] *See Nanopierce Technologies, Inc. vs. The Depository Trust and Clearing Corporation* , Supreme Court of Nevada, Case No. 45364, Brief of the Securities and Exchange Commission (February 2006).

[7] *Id.*

> For example, broker-dealers that make a market in a security generally stand ready to buy and sell the security on a regular and continuous basis at a publicly quoted price, even when there are no other buyers or sellers. Thus, market makers must sell a security to a buyer even when there are temporary shortages of that security available in the market. This may occur, for example, if there is a sudden surge in buying interest in that security, or if few investors are selling the security at that time. Because it may take a market maker considerable time to purchase or arrange to borrow the security, a market maker engaged in bona fide market making, particularly in a fast-moving market, may need to sell the security short without having arranged to borrow shares.[8]

It is therefore important to know which activity is the focus of discussion, including the following:

(1) selling stock short without having located stock for delivery at settlement. This activity would generally violate Regulation SHO, which, as described in greater detail below, places an obligation on broker-dealers to “locate” securities available for borrowing.

(2) selling stock short and failing to deliver shares at the time of settlement. This activity doesn’t necessarily violate any rules, because there are legitimate reasons why a seller may not have the stock available on settlement day.

(3) selling stock short and failing to deliver at settlement with the purpose of driving down the security’s price. This manipulative activity may be addressed by Regulation SHO (*i.e.*, to the extent the broker-dealer did not obtain a locate), and generally would also violate various securities laws, including the general antifraud and anti-manipulation provisions.

IV. SEC REGULATION OF SHORT SELLING

While, as noted above, the SEC has observed on many occasions the benefits of short selling, including contributing to market liquidity and enhancing pricing efficiency, the Commission also has recognized that short selling can cause market operational problems and can be used as a tool for manipulation. In recognition of the need to guard against improper uses of short selling, Congress provided the SEC with broad authority to regulate short sales, including but not limited to under Section 10(a) of the Securities Exchange Act of 1934 (“Exchange Act”). The SEC has used such authority to adopt various rules and regulations governing short selling.

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[8] SEC, *Division of Market Regulation: Key Points About Regulation SHO* (April 11, 2005).

Chief among these rules is Regulation SHO, which the SEC adopted in 2004 and implemented in early 2005 to provide comprehensive federal regulation over all short sale activities. Among other things, Regulation SHO is expressly designed to prevent potentially manipulative naked short selling and, toward that end, imposes the following requirements: (i) all "short" sales must be marked as such; (ii) prior to effecting a short sale for its own account, or on behalf of a customer, a broker-dealer must "locate" securities available for borrowing; and (iii) broker-dealers are required to close-out fails-to-deliver in certain "Threshold Securities" (*i.e.*, securities with high settlement failures) by purchasing securities in the open market and delivering them to eliminate the open fail.

The SEC has concluded that Regulation SHO has overall been successful. According to the SEC: (i) approximately 99% (by dollar value) of all trades settle on time; (ii) the average daily aggregate fails-to-deliver declined by 34.0% after the effective date of Regulation SHO; (iii) the average daily number of "Threshold Securities" declined by 38.2% and is continuing to decline over time; (iv) a total of 6,223 securities "graduated" from the Threshold Security list since the effective date of the Regulation, representing 4.5 billion shares in initial fails; (v) 99.2% of the fails that existed on January 3, 2005 (the effective date of the rule) were no longer outstanding as of March 31, 2006; and (vi) only 6 securities have persisted on the Threshold List, and even these 6 securities have seen their fails drop by 68.6%.[9]

This being the case, the SEC has continued to actively monitor and interpret Regulation SHO. Indeed, while the original regulation has been in place for less than three years, the SEC has recently amended the rule to further reduce instances where a seller fails-to-deliver the securities sold. For example, in response to concerns that a small number of issuers were remaining on the Threshold Lists for extended periods of time, the SEC has eliminated a prior exception from the close-out requirement for fails-to-deliver that were established prior to the security becoming a Threshold Security (the so called "grandfather provision"). This amendment actually has just gone into effect today, and is expected to result in a decrease in fails in Threshold Securities, as well as a decreased number of Threshold Securities overall. What is more, the SEC has proposed, and is actively reviewing comments on, other rule amendments which would eliminate or modify a current exception from the Regulation SHO close-out requirement for options market makers hedging pre-existing options positions.

Moreover, the SEC and the self-regulatory organizations (the "SROs") have been extremely active in examining and enforcing compliance with Regulation SHO and other rules directed at short selling activities, including a rule which specifically governs short selling in connection with a public offering, Rule 105 of Regulation M; the SEC has

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[9] Memorandum from SEC's Office of Economic Analysis re: *Fails to Deliver Pre- and Post-Regulation SHO* (August 21, 2006).

actually also recently taken action to strengthen this rule.[10] Since Regulation SHO first went into effect in 2005, there have been over 50 disciplinary actions by the SEC and the SROs addressing violations of short sale regulations (including Regulation SHO, Rule 105 of Regulation M, and the former SEC "tick" and NASD "bid" tests) and/or manipulative short selling activity (including short selling in connection with private offerings or so called "PIPEs"). This includes a recent SEC action (announced just last week) imposing a fine of approximately $8 million against a hedge fund for short sale violations, two fines by the American Stock Exchange ("AMEX") of approximately $4 million and $3 million, respectively, against two market makers for violations of Regulation SHO (announced in August 2007), and another recent fine by the SEC of over $2.7 million against a hedge fund for violations of Rule 105 of Regulation M (announced in June 2007).

In addition to Regulation SHO, manipulation of security prices is illegal, and is one of the primary concerns of the SEC and the SROs because of its pernicious effect on market integrity and the investing public. Accordingly, the SEC and the SROs have a wide array of laws and rules to deter and detect manipulation, including Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Market manipulation can also be prosecuted criminally.

As briefly outlined above, short selling is subject to a comprehensive regulatory scheme, and compliance with those regulations is very much in the forefront of the regulators' agenda. One of the main purposes of the SEC's adoption of Regulation SHO was to create a uniform set of requirements for short sales and, as part of that process, the SROs were required to rescind their overlapping (and occasionally disparate) rules. SIFMA believes it would be a mistake to reintroduce differences and disparities in short sale regulation, either on the federal or the state level.

V. ATTEMPTS AT STATE REGULATION OF SHORT SELLING

Despite the extensive regulation and enforcement over short selling activities by the SEC and the SROs, as described above, some groups have encouraged various states to enact their own, individual, short sale regulations. These efforts have included trying to have states enact laws which either prohibit short selling in the state altogether, or else require broker-dealers registered in such state to publicly report information on fails-to-deliver to the state. For example, the State of Utah enacted short selling legislation in a one day special session but then repealed it several months later when the legislature reconvened. Arizona, Oklahoma, and Virginia considered short selling bills, but did not adopt them. In trying to convince states to take up such efforts, these groups have generally alleged that the federal government has taken the role of an idle bystander and thus states need to step in to fill the void. As evidenced by the above, nothing could be further from the truth.

[10] Securities Exchange Act Release No. 56202 (August 6, 2006), 72 FR 45094 (August 10, 2007).

Furthermore, SIFMA believes that attempts by states to regulate in this area are expressly preempted by the National Securities Markets Improvement Act of 1996 ("NSMIA"), which was intended to eliminate duplicative and unnecessary regulatory burdens by assigning responsibility over a number of aspects of the nation's securities markets exclusively to the federal government. Among other things, NSMIA precludes states from enacting laws that impose upon broker-dealers new or additional operational reporting and recordkeeping requirements not provided for under the federal securities laws. Specifically, Section 15(h)(1) of the Exchange Act mandates that no state law shall establish "operational reporting requirements" for broker-dealers, or impose requirements with respect to broker-dealers' "making and keeping records," in a manner different from, or in addition to, the requirements of the Exchange Act. Any requirement for broker-dealers to collect data on fails-to-deliver in certain issuers domiciled in a specific state, and report such information to that state, is not in fact required under any federal or SRO regulation or rule, and SIFMA believes would thereby be prohibited by Section 15(h)(1).

In addition to being expressly preempted by NSMIA, SIFMA believes any such state regulation would also be impliedly preempted because it would seek to regulate an area, the national clearance and settlement system, for which Congress delegated exclusive authority to the SEC (pursuant to Section 17A of the Exchange Act) in the wake of the aforementioned crisis in the clearance and settlement system in the 1970's. The SEC has already regulated in this area, specifically considered the issues that would be addressed by any such state regulation, and has concluded that its regulations have been effective in addressing potential manipulation.

It is notable that these assertions are not only those of SIFMA alone, but have also been confirmed by a number of courts. Specifically, as you may be aware, a number of issuers and other individuals have brought lawsuits against the Depository Trust and Clearing Corporation ("DTCC"), a clearing agency registered with the SEC, generally alleging that DTCC has facilitated manipulative naked short selling. The SEC has filed Amicus briefs in such cases in defense of DTCC.[11] SIFMA believes that these lawsuits have virtually all been dismissed, with the courts generally basing such decisions on preemption grounds. One such court decision states such rationale for dismissal with precision:

> Defendants superbly document the pervasiveness of Congressional regulation of the national securities market. Since 1934, Congress has called for uniform regulation of the national securities markets. In 1975, Congress added Section 17A to the Securities Exchange Act ("Act") to remove impediments to a uniform national system for the prompt and accurate clearance and settlement of securities transactions. Congress adopted Section 17A as a means of

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[11] *See, supra* n. 6.

> remedying inefficient clearance and settlement procedures that "imposed unnecessary costs on investors and those acting on their behalf." One of the goals of Section 17A was "the development of uniform standards and procedures for clearance and settlement [of securities transactions]. Congress vested the Securities and Exchange Commission ("SEC") with the authority to preside over a uniform national system for the purpose of increasing efficiency and reducing risk…In light of the explicit Congressional goal of "the development of uniform standards and procedures for clearance and settlement [of securities transactions]" it is manifest that federal law preempts Plaintiffs' negligence claim.

What is more, any data collection and reporting requirements that would be imposed under such state regulation would be extremely impracticable, if not impossible, given the above-referenced operation of CNS. Specifically, as noted in detail above, such system does not track trade-by-trade settlement information, but rather nets all of a broker-dealer's buy and sell transactions each day down to one obligation to deliver or receive securities. In other words, in order to identify trade-by-trade settlement information, the nation's securities settlement system would essentially have to be re-built to comply with a specific state's requirements. SIFMA believes that such state regulation that would jeopardize the operation of CNS and, in turn, the efficient functioning of the national clearance and settlement system, would impose an excessive burden on interstate commerce that would be completely out of proportion to the local benefits of such state regulation, and would therefore violate the Commerce Clause.

VII. CONCLUSION

Contrary to the views expressed by some, short selling is not "un-American," particularly when it is on the basis of information obtained from a variety of sources and some of which contradicts the conventional wisdom. Information released by public companies does not reflect all that is known — or should be known — about such companies. Short selling helps to correct mispricing of stocks and in that way it contributes importantly to the honesty and fairness of our markets. It does so in particular by:

- Identifying overvalued securities and causing their prices to return to more appropriate levels.
- Identifying companies whose public disclosures and accounting are false or misleading.
- Providing liquidity to the markets and assists in price formation and price discovery.
- Providing handsome returns to the investors — often pension funds and other aggregators of wealth who represent the savings of many thousands of U.S. individuals.

- Offering a means by which those who have formed negative views on the competence or integrity of incumbent management can act on those views, often to the displeasure of companies like Enron Corporation and some of the other companies complaining the most vociferously about short sellers.

This being the case, as noted in detail above, while the SEC recognizes the many benefits associated with short selling, it is also mindful of the potential abuses, particularly with respect to "naked" short selling. To this end, it has adopted stringent and comprehensive regulations specifically designed to prevent potential naked short selling abuses. What is more, despite what some commenters would like you to believe, the SEC has been an extremely active "cop on the beat" with respect to short selling activities, closely monitoring and amending its regulations, as necessary, and bringing numerous enforcements actions (along with separate actions by the SROs) for violative and/or abusive short selling practices. SIFMA strongly believes that there is therefore not only no need for states to enact separate short sale regulations, but also believes that any such regulations would ultimately be found to be expressly and impliedly preempted by federal securities laws and regulations, and therefore invalid under the Supremacy Clause of the United States Constitution.

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We thank the Committee for the opportunity to allow SIFMA to share its views with you on this important topic.