Materials on “Naked” Short Selling

September 18, 2008

John C. Coffee, Jr.


Item Two: Existing Rule 203 of Regulation SHO (17 CFR §242.200 et seq.)

Item Three: SEC Press Release “SEC Issues New Rules to Protect Investors Against Naked Short Selling”


Item Six: Wachtell, Lipton, Rosen & Katz memo, “Too Little, Too Late”

Item Seven: Excerpt from Exchange Act Release No. 34-58107 (July 7, 2008)

Item Eight: Statements of SEC Chairman Cox and Enforcement Director Thomsen Regarding Immediate Commission Actions to Combat Market Manipulation (September 17, 2008)
"Naked" short selling is discouraged, but not prohibited. Indeed, the level of current encouragement is probably accurately described as only a mild chill. Still, the U.S. Securities and Exchange Commission (SEC) is considering proposed rules to deepern the chill that "nudist" short sellers must endure to engage in an activity that seems to be increasingly popular. This column will review the options.

As reported by "Bloomberg" short selling, "naked" short selling can be defined as the selling of an equity security that the seller neither owns, nor has borrowed, nor has arranged to borrow. Under Rule 10b5(1) of Regulation SHO, a broker-dealer may not accept a short-sale order unless it has "reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due." This so-called "borrower" requirement is subject to a number of exceptions and interpretations. For example, it does not apply to market makers in the security. Also, the broker can establish "reasonable grounds" by relying on a current "Easy to Borrow" list or by obtaining an assurance from a customer that the customer can obtain securities from another identified source in time to settle the trade. See Securities Exchange Act Release No. 34-57511 at ¶33 (March 17, 2008).

These exceptions may vary over time and by rule, particularly because a broker has little incentive to discount its customer's assurance or to look behind "Easy to Borrow" lists. Indeed, several brokers may rely on the same "available" shares. Thus, giving rise to naked short sales that are a multiple of the shares actually specified.

As a result, when the SEC got serious this year about restricting naked short sales in the case of a limited number of financial stocks, it imposed a temporary "pre-borrow" condition for those 19 stocks. That restriction has now expired, but the most obvious reform would be for the SEC to generalize this "pre-borrow" rule for all stocks.

Many argue that naked and covered shorting are similar.

Still, many financial economists argue that speculative short selling is necessary to maintain market efficiency and that "naked" shorting does not differ significantly from "covered" shorting -- at least once one understands the actual market mechanics. When a short seller borrows stock from a lender to make a covered short sale, the proceeds of the sale remain in the borrower's account until the borrowed stock is replaced and interest on those proceeds is shared by the two sides according to a negotiated rate. When a "naked" short sale is instead made, the proceeds remain in the buyer's account until the shares are delivered, but the short seller escaping the obligation to pay interest over the interval between sale and settlement. If there is a failure to deliver on the settlement date (i.e., trade date plus three days, or +3), the undeliverable to the buyer will also earn interest on the purchase price, but the rate may often be lower.

The risk of a failure to deliver by the naked short seller falls not on the issuer, but on the National Securities Clearing Corp.
(NSSC), which clears and settles all trades in regulated equity securities and must discharge all obligations of its member banks. Typically, the NSSC will receive failure to deliver by itself borrowing the shares from its members under its Stock Borrow Program. Hence, the buyer will usually receive reasonably quickly delivered at the agreed-up price. From this perspective, "naked" shorting can be seen as primarily a means of economizing on the financing costs of short selling. Market makes in particular are likely to use this technique and fail to deliver as long as the interest rate that they thereby pay is less than that charged by a stock lender. See Christopher Cabr and J.B. Healan, "Naked Shorting," http://ssrn.com/abstract=642389 (April 2007).

That's one side of the story. The other side is that, even if naked shorting does not hurt the buyer, it injures others by creating an artificial immove in the supply of shares (and thus lowering the stock price) and by increasing the volatility of the stock. There, there has long been a debate as to the magnitude of these effects. When in 2007 the SEC abolished the "uptick" rule that permitted short sales only in an increasing or market level, it did so largely on the basis of its own economic study of the impact of short selling on intraday price reversals. That study found that eliminating short selling constraints increased the frequency of very short-term price reversals (measured in terms of five-minute intervals), but diminished the frequency of longer term-price changes (measured in terms of 30 minute intervals). See SEC, Economic Analysis of the Short Sale Price Restrictions Under Regulation SHO (2006). On balance, then, overall volatility did not seem much affected.


Study shows short seller exacerbate price declines

Put differently, short sellers do not initially cause price declines, but they do significantly exacerbate them, with the magnitude of the price decline being "directly proportional to the degree of abnormal short selling." In this study, the stocks most likely to be affected by short selling were not, as traditionally believed, those of small and illiquid companies, but rather those of large corporations that were heavily owned by institutions (possibly because institutions are usually the source of stock loans to short sellers). From this perspective, the victim is less the counterparty of the short seller than the corporation and the market.

Nonetheless, the danger in any reform is that the baby may get thrown out with the bath. Much as corporate managers hate short sellers, the battle between manipulators and the short-sellers is usually one between stuffs Christians and stuffs weeks. Reform becomes necessary when it seeks beyond driving naked short-selling and seeks to restrict covered short sales as well. In this light, imposing a "pre-borrow" requirement in place of the current "locate" requirement in Rule 10b-5a(b) simply raise the finance charge to the short seller and forces it to find a commercial lender. Even all short sellers were required to borrow the stock at the time of the sale, they would have to pay interest lender on the borrowed shares (i.e., the T+3 interval) and the effective interest rates would likely rise as the number of borrowers would increase while the number of stock lenders would remain relatively fixed over the short run.

Other proposals, such as reinstating some modified form of the "uptick" rule, constrain all forms of short selling. Recently, the SEC has hinted that it might preclude short sales only after some defined fall or cascade in the stock's price, much the way the SEC's circuit breaker works. This is a defensible intermediate position, but it arguably still imposes market efficiency.

What further reforms would make sense? The SEC has begun to curtail its exemptions for option market makers. See Exchange Act Release No. 34-31027 (July 7, 2008). But it needs to go further. Otherwise, restricted naked short sellers may just extend speculation to move to the put option market, with the market maker than engaging in naked short selling to hedge its long position.

An even more logical change would be to rein in the NSSC's elaborate Stock Borrow Program, which essentially roasts at customers with the goal of reducing market volatility. Effectively, when the NSSC borrows stock from its members to cover failure to deliver, it is essentially repaying and even increasing the naked short seller. Recently, some corporations used to challenge this program on state-law grounds, but the U.S. Circuit Court of Appeals properly found last month that SEC approval of the NSSC's procedures pre-empts state-law claims. See Rivers Investment Funds v. The Depository Trust and Clear Corp., No. 06-16888, 2008 U.S. App. Lexis 18024 (9th Cir. Aug. 22, 2008). Still, as a policy matter, if the SEC were instead to require immediate buy-ins of the stock on failure to deliver, there would be matching purchases in the market to offset the naked sales, and supply and demand would thus come back to a closer balance.

Requiring substantial short sellers to disclose identities

Finally, the most logical and least costly reform in terms of market efficiency involves disclosure. The truly sinister scenario surrounding short selling involves price manipulation through false rumors and other forms of deception. Although the SEC regularly investigates such cases, it has seldom been able to catch a true villain. Thus, it may be desirable to require substantial short sellers to disclose their identities and short positions, presently at an early level, such as 1% of the class. As in the case of Schedule 130 order the Williams Act, persons belonging to a "group" should be required to disclose their aggregate short position if they have reached any agreement on understanding regarding acting in concert.

The SEC has ample authority to require disclosure under S. Section 10. of the Securities Exchange of 1934, which authorizes it to adopt any rules regarding short selling as it deems necessary or appropriate in the public interest or for the protection of investors. At the least, such a rule would alert the market to who has an incentive to mislead. Ultimately, transparency should apply to both the long and the short side of the market.

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Subtext to The National Law Journal
Rule 203. Borrowing and Delivery Requirements

(a) Long Sales. (1) A broker or dealer may not accept a short sale order in an equity security from another person, or effect a short sale in an equity security for its own account, unless the broker or dealer has:

(i) Borrowed the security, or entered into a bonafide arrangement to borrow the security;
(ii) Reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due;
(iii) Documented compliance with this paragraph (b)(1).

(b) The provisions of paragraph (a)(1) of this rule shall not apply:

(i) To the loan of any security by a broker or dealer through the medium of a loan to another broker or dealer;
(ii) If the broker or dealer knows, or has been reasonably informed by the seller, that the seller owns the security, and that the seller would deliver the security to the broker or dealer prior to the scheduled settlement of the transaction, but the seller failed to do so;

(c) If, prior to any loan or arrangement to loan any security for delivery, or failure to deliver, a national securities exchange, in the case of a sale effected thereon, or a national securities association, in the case of a sale not effected on an exchange, finds:

(A) That such sale resulted from a mistake made in good faith;
(B) That due diligence was used to ascertain that the circumstances specified in Rule 200(g) existed; and
(C) Either that the condition of the market at the time the mistake was discovered was such that undue hardship would result from covering the transaction by a “purchase for cash” or that the mistake was made by the seller's broker and the sale was at a permissible price under any applicable short sale price test.

(ii) Short Sales. (1) A broker or dealer may not accept a short sale order in an equity security from another person, or effect a short sale in an equity security for its own account, unless the broker or dealer has:

(i) Borrowed the security, or entered into a bonafide arrangement to borrow the security; or
(ii) Documented compliance with this paragraph (b)(1).

(2) The provisions of paragraph (b)(1) of this rule shall not apply to:

(i) A broker or dealer that has accepted a short sale order from another registered broker or dealer that is required to comply with paragraph (b)(1) of this rule, unless the broker or dealer relying on this exception contrarily underwrote responsibility for compliance with paragraph (b)(1) of this rule;
(ii) Any sale of a security that a person is deemed to own pursuant to Rule 200, provided that the broker or dealer has been reasonably informed that the person intends to deliver such security as soon as all restrictions on delivery have been removed. If the person has not delivered such security within 35 days after the trade date, the broker-dealer that effected the sale must borrow securities or close out the short position by purchasing securities of like kind and quantity;
(iii) Short sales effected by a market maker in connection with bona-fide mar-
ked making activities in the security for which this exception is claimed, and
(iv) Transactions in security futures.

(3) If a participant of a registered clearing agency has a fail to deliver position at a
registered clearing agency in a threshold security for thirteen consecutive settlement
days, the participant shall immediately thereafter close out the fail to deliver posi-
tion by purchasing securities of like kind and quantity:

(i) Provided, however, that a participant of a registered clearing agency that has a
fail to deliver position at a registered clearing agency in a threshold security on
the effective date of this amendment and which, prior to the effective date of this
amendment, had been previously condoned from the close-out requirement in
this paragraph (b)(3) (i.e., because the participant of a registered clearing agency
had a fail to deliver position at a regis-
tered clearing agency on the settlement
day preceding the day that the security
became a threshold security), shall close
out that fail to deliver position within
thirty-five consecutive settlement days of
the effective date of this amendment by
purchasing securities of like kind and
quantity;

(ii) Provided, however, that if a partici-
pant of a registered clearing agency has a
fail to deliver position at a registered
clearing agency in a threshold security that was sold pursuant to § 210.144 of
this chapter for thirty-five consecutive
settlement days, the participant shall im-
immediately thereafter close out the fail to
deliver position in the security by pur-
chasing securities of like kind and qua-
itv;

(iii) The provisions of this paragraph
(b)(3) shall not apply to the amount of the
fail to deliver position in the threshold
security that is attributed to short sales by
a registered options market maker, if and
to the extent that the short sales are
effectuated by the registered options market
maker to establish or maintain a hedge on
options positions that were created before
the security became a threshold security.
SEC Issues New Rules to Protect Investors Against Naked Short Selling Abuses

FOR IMMEDIATE RELEASE
2008-204

Washington, D.C., Sept. 17, 2008 - The Securities and Exchange Commission today took several coordinated actions to strengthen investor protections against "naked" short selling. The Commission's actions will apply to the securities of all public companies, including all companies in the financial sector. The actions are effective at 12:01 a.m. ET on Thursday, Sept. 18, 2008.

"These several actions today make it crystal clear that the SEC has zero tolerance for abusive naked short selling," said SEC Chairman Christopher Cox. "The Enforcement Division, the Office of Compliance Inspections and Examinations, and the Division of Trading and Markets will now have these weapons in their arsenal in their continuing battle to stop unlawful manipulation."

In an ordinary short sale, the short seller borrows a stock and sells it, with the understanding that the loan must be repaid by buying the stock in the market (hopefully at a lower price), but in an abusive naked short transaction, the seller doesn't actually borrow the stock, and fails to deliver it to the buyer. For this reason, naked shorting can allow manipulators to force prices down far lower than would be possible in legitimate short-selling conditions.

Today's Commission actions, which are the result of rulemaking under the Administrative Procedure Act, go beyond its previously issued emergency order, which was limited to the securities of financial firms with access to the Federal Reserve's Primary Dealer Credit Facility. Because the agency's exercise of its emergency authority is limited to 30 days, the previous order under Section 12(k)(2) of the Securities Exchange Act of 1934 expired on Aug. 19, 2008.

The Commission's actions were as follows:

Hard T+3 Close-Out Requirement; Penalties for Violation Include Prohibition of Further Short Sales, Mandatory Pre-Borrow

The Commission adopted, on an interim final basis, a new rule requiring that short sellers and their broker-dealers deliver securities by the close of business on the settlement date (three days after the sale transaction date, or T+3) and imposing penalties for failure to do so.

If a short sale violates this close-out requirement, then any broker-dealer acting on the short seller's behalf will be prohibited from further short sales in the same security unless the shares are not only located but also pre-borrowed. The prohibition on the broker-dealer's activity applies not only to

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short sales for the particular naked short seller, but to all short sales for any customer.

Although the rule will be effective immediately, the Commission is seeking comment during a period of 30 days on all aspects of the rule. The Commission expects to follow further rulemaking procedures at the expiration of the comment period.

**Exception for Options Market Makers from Short Selling Close-Out Provisions in Reg SHO Repealed**

The Commission approved a final rule to eliminate the options-market maker exception from the close-out requirement of Rule 203(b)(3) in Regulation SHO. This rule change also becomes effective at 12:01 a.m. ET on Thursday, Sept. 18, 2008.

As a result, options market makers will be treated in the same way as all other market participants, and required to abide by the trade T+3 closeout requirements that effectively ban naked short selling.

**Rule 10b-21 Short Selling Anti-Fraud Rule**

The Commission adopted Rule 10b-21, which expressly targets fraudulent short selling transactions. The new rule covers short sellers who deceive broker-dealers or any other market participants. Specifically, the new rule makes clear that those who lie about their intention or ability to deliver securities in time for settlement are violating the law when they fail to deliver. This rule also becomes effective at 12:01 a.m. ET on Thursday, 2008.


Price-Destabilizing Short Selling

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Abstract:
We present empirical evidence of short sellers’ price-destabilizing activities during intraday liquidity crises. At the outset of such crises, following negative non-short order imbalances and liquidity shortages, shorting substantially intensifies and, subsequently, declines as prices approach intraday maxima. Short selling in our sample is aggressive, and its effect on price declines is beyond that of merely mechanical. Stocks that are susceptible to intraday liquidity crises have high institutional ownership and high short interest. Liquidity crises are recurring, mildly contagious, and cannot be fully attributed to news releases. Aggressive short selling episodes cause a decline in the number of institutional holders.

Keywords: Short selling, price manipulation, speculative and predatory trading, order imbalances

JEL Classifications: G14, G19

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close-out requirement contained in paragraph (b)(3)(iii) of this section has a fail to deliver position at a registered clearing agency in the threshold security for 35 consecutive settlement days, the participant and any broker or dealer for which it clears transactions, including any market maker, that would otherwise be entitled to rely on the exception provided in paragraph (b)(3)(ii) of this section, may not accept a short sale order [*206] in the threshold security from another person, or effect a short sale in the threshold security for its own account, without borrowing the security or entering into a bona fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity;

* * *

(ix) To the extent that an amount of a fail to deliver position in a threshold security is attributed to short sales by a registered options market maker in accordance with paragraph (b)(3)(ii) of this section, a participant of a registered clearing agency and registered options market maker must document that the fail to deliver position resulted from short sales effected to establish or maintain a hedge on options series that were created before the security became a threshold security.

S. Alternative 2: alternatively, Section 242.203 is proposed to be amended by:
a. Revising paragraph (b)(3)(iii);
b. Redesignating paragraphs (b)(3)(vi) and (b)(3)(vii) as paragraphs (b)(3)(viii) and (b)(3)(ix);
c. Adding new paragraphs (b)(3)(vii), (b)(3)(viii) and (b)(3)(x);
d. Removing the word 'and' at the end of paragraph (b)(3)(vi); and
e. Revising newly designated [*207] paragraph (b)(3)(ix) by adding the word "and" after the semi-colon at the end of the paragraph.

The revisions and additions read as follows:

§ 242.203 Borrowing and delivery requirements.

* * *

(b) * * *

(3) * * *

(iii) The provisions of paragraph (b)(3) of this section shall not apply to the amount of the fail to deliver position in the threshold security that is attributed to short sales by a registered options market maker, if to and the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on any options series in a portfolio that were created before the security became a threshold security;

'A' Provided, however, that if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a threshold security that is attributed to short sales by a registered options market maker, if to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on options series that were created before the security became a threshold security, the participant shall close out the fail to deliver position, including any adjustments [*208] to the fail to deliver position, by purchasing securities of like kind and quantity within the earlier of: (1) 35 consecutive settlement days from the date on which the security became a threshold security, or (2) 13 consecutive settlement days from the last date on which all options series within the portfolio that were created before the underlying security became a threshold security expire or are liquidated;

(B) Provided, however, that a participant of a registered clearing agency that has a fail to deliver position at a registered clearing agency in a threshold security on the effective date of this amendment which, prior to the effective date of this amendment, had been previously excepted from the close-out requirement in

http://www.lexis.com/research/retrieve?m=7e608a8bec97c65e11014a4bd419fca&doctype=3&_fistar=... 9/17/2008
paragraph (b)(3) of this section (i.e., because the participant of a registered clearing agency had a fail to deliver position in the threshold security that is attributed to short sales by a registered options market maker, if and to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on options positions that were created before the security became a threshold security), shall [**209] immediately close out that fail to deliver position, including any adjustments to the fail to deliver position, within 35 consecutive settlement days of the effective date of this amendment by purchasing securities of like kind and quantity; * * * *

(vi) If a participant of a registered clearing agency entitled to rely on the exception to the close-out requirement contained in paragraph (b)(3)(ii)(A) of this section has a fail to deliver position at a registered clearing agency in a threshold security for longer than the earlier of: (1) 15 consecutive settlement days from the date on which the security became a threshold security, or (2) 13 consecutive settlement days from the last date on which all options series within the portfolio that were created before the security became a threshold security expire or are liquidated, the participant and any broker or dealer for which it clears transactions, including any market maker that would otherwise be entitled to rely on the exception provided in paragraph (b)(2)(ii) of this section, may not accept a short sale order in the threshold security from another person, or effect a short sale in the threshold security for its own account, without borrowing the security or entering into a bona fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity;

(vii) If a participant of a registered clearing agency entitled to rely on the 35 consecutive settlement day close-out requirement contained in paragraph (b)(3)(ii)(B) of this section has a fail to deliver position at a registered clearing agency in the threshold security for 35 consecutive settlement days from the effective date of the amendment, the participant and any broker or dealer for which it clears transactions, including any market maker, that would otherwise be entitled to rely on the exception provided in paragraph (b)(2)(ii) of this section, may not accept a short sale order in the threshold security from another person, or effect a short sale in the threshold security for its own account, without borrowing the security or entering into a bona fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity; * * * *

(x) To the extent that an amount of a fail to deliver position [*211] in a threshold security is attributed to short sales by a registered options market maker in accordance with paragraph (b)(3)(iii) of this section, a participant of a registered clearing agency and registered options market maker must document that the fail to deliver position resulted from short sales effected to establish or maintain a hedge on options series that were created before the security became a threshold security.

By the Commission.

Legal Topics:

For related research and practice materials, see the following legal topics:

Computer & Internet Law > Privacy & Security > General Overview

Contracts Law > Types of Contracts > Rights

Securities Law > Self-Regulating Entities > National Association of Securities Dealers

08/09/2007

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Date/Time: Wednesday, September 17, 2008 - 2:36 PM EDT

http://www.lexis.com/research/retrieve?_m=76d68a8bccc97c6e11014fa4f1d199ca&docnum=3&fmtstr=... 9/17/2008
September 17, 2008

Too Little Too Late

The SEC today announced three actions addressing short selling. Its actions are too little too late.

First, the SEC adopted a rule requiring short sellers and their broker-dealers to deliver securities by the settlement date (three days after the transaction date) and imposing penalties for failure to do so. In addition, the SEC eliminated the option market-maker exception to the three day delivery requirement. Finally, the SEC adopted a new anti-fraud provision making it unlawful for sellers to deceive specified persons about their ability or intention to deliver securities by the settlement date. This last rule is not necessary and will not help eliminate abusive short selling practices.

The measures adopted by the SEC today fall far short of the type of bold measures needed to constrain the abusive short selling and rumor mongering taking place. The securities markets continue to be in a crisis and there continues to be a significant disruption to their fair and orderly functioning.

As we have previously said, the SEC should immediately re-impose, under its emergency powers, the "Uptick Rule." In addition, the SEC must now consider other very strong measures such as using its emergency powers to place limitations on short sales for a period of time to restore a fair and orderly market. Also, it is essential for the SEC to scrutinize short sellers and their related transactions, including options and credit default swaps to determine whether these strategies are contributing to the severe dislocations taking place in the marketplace.

Finally, the SEC should promptly make public the results of their examinations of the short selling activities and take immediate enforcement action against those who are engaging in this abusive manipulative conduct.

Time is of the essence and the SEC must act now.

Edward D. Herlihy
Theodore A. Levine
data indicated that the options market maker exception was claimed in 20 threshold securities for a total of 6,963,949 fails to deliver.

In addition, the Commission is releasing the results of a recent analysis by the Commission's Office of Economic Analysis ("OEA") of fails to deliver before and after the elimination of Regulation SDO's "grandfather" provision. As set forth below, these results show that extended fails to deliver in non-optional threshold securities declined significantly after the elimination of the "grandfather" provision while extended fails to deliver in optional threshold securities increased significantly. Specifically, changes for optional threshold securities include:

- The average daily number of optional threshold list securities increased by 25.0%.
- The average daily number of new fail to deliver positions in optional threshold securities increased by 45.3%.
- For fails aged more than 17 days in optional threshold securities, the average daily dollar value of fails to deliver increased by 73.4%.
- For fails aged more than 17 days in optional threshold securities, the average daily number of fail to deliver positions increased by 30.7%.
- The average daily number of optional threshold list securities with fails aged more than 17 days increased by 40.9%.

Further, changes for non-optional threshold securities include:

- The average daily number of non-optional threshold list securities decreased by 3.5%.
- The average daily number of new fail to deliver positions in non-optional threshold securities increased by 7.4%.
- For fails aged more than 17 days in non-optional threshold securities, the average daily dollar value of fails to deliver decreased by 34.5%.
- For fails aged more than 17 days in non-optional threshold securities, the average daily number of fail to deliver positions decreased by 38.8%.

See Memorandum from the Commission’s Office of Economic Analysis (dated June 9, 2008), which is available on the Commission’s internet website at http://www.sec.gov/ommnemarx7/97771907.html (the "OEA Memorandum"). As discussed above, the "grandfather" provision was eliminated as of October 15, 2007 with a one-year phase-in period which expired on December 5, 2007. The sample data used in the OEA Memorandum compares two time periods: April 9, 2007 – October 14, 2007, which is defined as the "pre-amendment period" and December 10, 2007 – March 31, 2008, which is defined as the "post-amendment period."
The average daily number of non-optionable threshold list securities with fails aged more than 17 days decreased by 32.6%.

To ascertain the extent to which fails to deliver were not being closed out due to the options market maker exception to the close-out requirement prior to the elimination of the "grandfather" provision, Commission staff obtained data from certain self-regulatory organizations for 2006 and 2007 regarding use of the options market maker exception. This data is explained in more detail below.

In 2007, as part of its regular Regulation SHO surveillance, the Financial Industry Regulatory Authority ("FINRA") conducted a review of securities with extended fails to deliver at the NSCC to ascertain the continuing cause of fails to deliver, and to also assess compliance with NYSE Rule 440/SEC and Regulation SHO. As set forth below, according to data provided by one NSCC participant that settles and clears for a large segment of the options market, a number of fails to deliver at that participant were not closed out due to claims that the fails were excepted from the close-out requirement as a result of the options market maker exception.

A review of the FINRA data for 2007 shows the following:

<table>
<thead>
<tr>
<th>Month</th>
<th>Fails to Deliver</th>
<th>No. of Securities</th>
</tr>
</thead>
<tbody>
<tr>
<td>February</td>
<td>35,665</td>
<td>1</td>
</tr>
<tr>
<td>March</td>
<td>900,276</td>
<td>5</td>
</tr>
<tr>
<td>April</td>
<td>3,433,639</td>
<td>8</td>
</tr>
<tr>
<td>May</td>
<td>228,878</td>
<td>2</td>
</tr>
<tr>
<td>June</td>
<td>2,441,122</td>
<td>14</td>
</tr>
<tr>
<td>July</td>
<td>462,414</td>
<td>6</td>
</tr>
<tr>
<td>August</td>
<td>3,065,710</td>
<td>12</td>
</tr>
</tbody>
</table>

See id.

NYSE Rule 440 requires that "[e]very member not associated with a member organization and every member organization shall make and preserve books and records as the Exchange may prescribe and as prescribed by Rule 17a-3." See id.

These numbers represent fails to deliver which, as explained in footnote 1 above, are shares of a security that are not delivered by settlement date. According to the data provided to FINRA, these fails to deliver were not closed out due to the options market maker exception.
<table>
<thead>
<tr>
<th>Month</th>
<th>Number of Fails</th>
<th># of Threshold Securities</th>
</tr>
</thead>
<tbody>
<tr>
<td>October</td>
<td>4,456,340</td>
<td>13</td>
</tr>
<tr>
<td>November</td>
<td>1,341,963</td>
<td>2</td>
</tr>
<tr>
<td>December</td>
<td>5,021,982</td>
<td>15</td>
</tr>
</tbody>
</table>

As indicated in the table above, the options market maker exception to the close-out requirement was claimed for a large number of fails to deliver for the entire year, including both before and after October 15, 2007, the effective date of the elimination of Regulation SHO’s “grandfather” provision.

On December 11, 2006 the Chicago Board of Options Exchange (“CBOE”) along with the American Stock Exchange, NYSE Arca, Inc., and the Philadelphia Stock Exchange initiated a Regulation SHO review of options market makers covering the time period from May through July 2006. The focus of these reviews was the options market maker exception to the close-out requirement for aged fails to deliver in threshold securities that were open for thirteen consecutive settlement days.69

According to CBOE, the reviews revealed that there were 598 exceptions claimed, covering 58 threshold securities for a total of 11,759,799 fails to deliver. For the 58 threshold securities identified, the number of fails to deliver for which an exemption was claimed from the close-out requirement ranged from 207 to 1,950,655.

The following is a distribution of the number of fails to deliver:

<table>
<thead>
<tr>
<th># of Fails to Deliver for which Exception Was Claimed</th>
<th># of Threshold Securities</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 - 100,000</td>
<td>35</td>
</tr>
<tr>
<td>100,001 - 200,000</td>
<td>4</td>
</tr>
<tr>
<td>200,001 - 300,000</td>
<td>4</td>
</tr>
<tr>
<td>300,001 - 400,000</td>
<td>5</td>
</tr>
<tr>
<td>400,001 - 500,000</td>
<td>4</td>
</tr>
<tr>
<td>500,001 - 600,000</td>
<td>2</td>
</tr>
</tbody>
</table>

69 The “grandfather” provision was also in effect during this period but was not the subject of these reviews.
600,001 - 700,000  
700,001 - 800,000 1  
800,001 - 900,000  
900,001 - 1,000,000 5  
> 1,000,000 2  

Therefore, the Commission is re-opening the comment period for Exchange Act Release No. 56213 from the date of this release through August 13, 2008.

By the Commission.

Florence E. Harmon  
Acting Secretary

Dated: July 7, 2008
WASHINGTON, D.C., Sept. 17, 2008—Securities and Exchange Commission Chairman Christopher Cox and SEC Enforcement Division Director Linda Chatman Thomsen issued the following statements today concerning ongoing and forthcoming Commission actions to investigate fraud and manipulation in the nation’s securities markets:

“Millions of investors entrust their savings to our securities markets because they can be confident that our markets are orderly, liquid, efficient, and rational,” said Chairman Cox. “The turmoil in today’s markets, particularly in the financial sector, is challenging that assumption for ordinary Americans. Markets are the best tool a free society has to price and allocate assets across a complex economy, but as is well known from experience, sometimes the wisdom of crowds is supplanted by crowd behavior. We need well-functioning markets to help us draw the line between reasonable miscalculation and error or something worse involving the failure of due diligence, self-dealing, and conflicts of interest. It is thus vitally important that the market mechanism continue to inspire investor confidence.

“In order to ensure that hidden manipulation, illegal naked short selling, or illegitimate trading tactics do not drive market behavior and undermine confidence, the SEC today took several actions to address short selling abuses,” Chairman Cox continued. “In addition to these initiatives, which will take effect at 12:01 a.m. ET on Thursday, I am asking the Commission to consider on an emergency basis a new disclosure rule that will require hedge funds and other large investors to disclose their short positions. Prepared by the staff of the Division of Investment Management and the Division of Corporation Finance, the new rule will be designed to ensure transparency in short selling. Managers with more than $100 million invested in securities would be required to promptly begin public reporting of their daily short positions. The managers currently report their long positions to the SEC.”

Chairman Cox continued, “Director Thomson and the Division of Enforcement will also expand their ongoing investigations by undertaking a series of additional enforcement measures against market manipulation. The Enforcement Division will obtain disclosure from significant hedge funds and other institutional traders of their past trading positions in specific securities. Those institutions will also be required immediately to secure all of their communication records in anticipation of subpoenas for these records.”

SEC Director of Enforcement Linda Chatman Thomsen said, “The Enforcement Division has been investigating and will continue to investigate any suggestion of manipulative
trading. We are committed to using every weapon in our arsenal to combat market manipulation that threatens investors and capital markets.”

The Commission is actively considering additional actions as appropriate.

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