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Report to Congressional Requesters

May 2009

REGULATION SHO

Recent Actions Appear to Have Initially Reduced Failures to Deliver, but More Industry Guidance Is Needed

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Highlights

Highlights of GAO-09-483, a report to congressional requesters

REGULATION SHO

Recent Actions Appear to Have Initially Reduced Failures to Deliver, but More Industry Guidance Is Needed

Why GAO Did This Study

The Securities and Exchange Commission (SEC) adopted Regulation SHO to, among other things, curb the potential for manipulative naked short selling in equity securities. Selling a security short without borrowing the securities needed to settle the trade within the standard 3-day period, can result in failures to deliver (FTD), and can be used to manipulate (drive down) the price of a security. To further address this concern, SEC recently issued an order amending Regulation SHO. This report (1) provides an overview of Regulation SHO and related SEC actions, (2) discusses regulators' and market participants' views on the effectiveness of the rule, and (3) analyzes regulators' efforts to enforce the rule.

To address these objectives, GAO reviewed SEC rules and draft industry guidance, analyzed FTD data, reviewed SEC and self-regulatory organization (SRO) examinations, and interviewed SEC and SRO officials and market participants.

What GAO Recommends

GAO recommends that the SEC Chairman expedite the review and approval of the draft guidance and develop a process to respond to implementation issues that arise from temporary rules. SEC stated that it would consider addressing the intent of the draft guidance in the temporary rule and evaluate how it can further address implementation concerns raised by the industry.

View GAO-09-483 or key components. For more information, contact Orice M. Williams at (202)-512-8678 or williamso@gao.gov.

What GAO Found

To address FTD and curb the potential for manipulative naked short selling in equity securities, Regulation SHO required broker-dealers to (1) locate securities available for borrowing before effecting short sales in that security and (2) close out FTD lasting ten consecutive settlement days in securities for which a substantial number of FTD accumulated (threshold securities). SEC imposed the close-out requirement only on threshold securities because it believed high levels of FTD could indicate potential manipulative naked short selling. Increasing market volatility led SEC to issue a September 2008 emergency order requiring broker-dealers to close out FTD resulting from short sales in any security the day after the settlement date. SEC extended this requirement until July 2009 in an interim final temporary rule. GAO found that the number of threshold securities declined after the implementation of the stricter close-out requirement, but it is not clear whether this trend can be sustained.

Some market participants believe that the stricter close-out requirement does not prevent manipulative trading from occurring within the 3-day settlement period. They recommend that SEC address potential abuse by requiring all short sellers to borrow securities before a short sale. As the Commission considers whether to finalize the temporary rule, SEC staff said that they are continuing to evaluate the appropriateness of a preborrow requirement for addressing FTD and market manipulation related to naked short selling. However, SEC staff said that the costs of a preborrow requirement might outweigh the benefits because FTD represent 0.01 percent of the dollar value of trades, and that a small group of securities (small market capitalization, thinly traded, or illiquid) are likely to be the target of any manipulative scheme.

SEC and SRO examiners have found that some broker-dealers do not monitor whether the source a broker-dealer uses to locate available securities is reasonable (i.e., does not result in FTD). The broker-dealers may not have done so because firms do not expect that the source from which it obtained the locate will be used to obtain shares for settlement. In some cases, the executing broker-dealer may lack information needed to establish whether the locates were reasonable. SEC staff worked with the industry to draft guidance in 2007 to clarify communication responsibilities in such instances, but SEC has not finalized it. As a result, some firms may continue to be noncompliant with the locate requirement. Furthermore, SEC sometimes did not provide interpretive guidance for questions on the implementation of Regulation SHO and temporary rule-related requirements, or did so after lengthy delays. SEC does not have formal processes for determining which requests for guidance merit a formal response, nor does it have a process by which implementation issues that arise from temporary rules can be readily addressed. Without timely and clear guidance to the industry, SEC cannot ensure the consistent implementation of its rules or help address the unintended consequences of operational issues that occur while awaiting rule expiry or finalization.

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Abbreviations

Amex	American Stock Exchange
CBOE	Chicago Board Options Exchange
CNS	Continuous Net Settlement
DTC	Depository Trust Company
DTCC	Depository Trust and Clearing Corporation
ETF	exchange-traded funds
FINRA	Financial Industry Regulatory Authority
FTD	failures to deliver
FTR	failures to receive
NASD	National Association of Securities Dealers (now FINRA)
NAV	net asset value
NSCC	National Securities Clearing Corporation
NYSE	New York Stock Exchange
OCIE	Office of Compliance Inspections and Examinations
OEA	Office of Economic Analysis
OTC	over the counter
OTCBB	Over-The-Counter Bulletin Board
SEC	Securities and Exchange Commission
SRO	self-regulatory organization
T	trade date
VIX	Chicago Board Options Exchange Volatility Index

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United States Government Accountability Office
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May 12, 2009

The Honorable Carl Levin
Chairman
Permanent Subcommittee on Investigations
Committee on Homeland Security
and Governmental Affairs
United States Senate

The Honorable Charles E. Grassley
Ranking Member
Committee on Finance
United States Senate

The Honorable Arlen Specter
United States Senate

When investors agree to trade an equity security, the buyer promises to deliver cash to the seller, and the seller promises to deliver the security to the buyer. The process by which the seller receives payment and the buyer receives the security is known as clearance and settlement. Trade clearance and settlement in the United States operates on a standard 3-day settlement cycle. Trades are executed on trade date (T) and settled 3 days later (T+3).[1] According to the Depository Trust and Clearing Corporation (DTCC), the holding company whose subsidiaries are responsible for clearing and settling broker-to-broker equity securities trades in the United States, 99.9 percent of daily transactions, by dollar volume, clear and settle within the standard 3-day settlement period.[2] In the remaining transactions (0.01 percent) the seller did not deliver the securities on time, resulting in failures to deliver (FTD). According to the Securities and Exchange Commission (SEC), FTD can be caused by mechanical error or processing

[1]We use the term "days" in this report when referring to settlement days, or those business days on which deliveries of securities and payments of money may be made through the facilities of a registered clearing agency.

[2]According to DTCC, its subsidiaries settle most broker-to-broker equity securities trades in the U.S. equity markets. This report does not address those trades that are cleared and settled outside of the clearing agency (ex-clearing).

delays, which are typically resolved in a few days. However, FTD also can result from naked short selling. While not defined in the federal securities laws or rules, according to SEC, naked short selling generally refers to selling short without having borrowed the securities to make delivery, potentially resulting in FTD.[3] When FTD persist for days or months, they can reach a level that may affect the market for that security. They also may be indicative of an illegal trading strategy known as manipulative naked short selling, in which short sellers attempt to profit by using naked short selling to flood the market with sales of a security with the intent of lowering its price. For several years, and more recently in the financial crisis, investors, publicly traded companies, and others have expressed concerns about the level of FTD in specific securities and the potential for manipulative naked short selling.

SEC has taken several actions in recent years intended to address FTD and the potential for manipulative naked short selling. In August 2004, SEC adopted Regulation SHO, which was intended to address large and persistent FTD and curb the potential for manipulative naked short selling.[4] Among other things, the regulation imposed (1) uniform requirements on broker-dealers to locate a source of securities available for borrowing prior to effecting a short sale in any equity security (generally referred to as performing a locate) and (2) delivery requirements on broker-dealers for equity securities in which a substantial amount of FTD had occurred, which the regulation designated as threshold securities.[5] Regulation SHO required broker-dealers that have FTD in these securities lasting for 10 consecutive days to "close out" the FTD by the beginning of regular trading hours the next morning (T+14) by

[3]A "short sale" is the sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. In general, short selling is used to profit from an expected downward price movement, provide liquidity in response to unanticipated demand, or hedge the risk of a long position (i.e., ownership) in the same or related security.

[4]See 69 Fed. Reg. 48008 (Aug. 6, 2004). Regulation SHO was adopted to update short sale regulation in light of numerous market developments since short sale regulation was first adopted in 1938.

[5]Regulation SHO defines a "threshold security" as an equity security where, for 5 consecutive settlement days, (1) there are aggregate FTD at a registered clearing agency of 10,000 shares or more, (2) the level of FTD is equal to at least one-half of 1 percent of the issuer's total shares or more, and (3) the security is included on a list published by self-regulatory organizations. To be removed from the threshold list, the level of FTD in a security must not exceed the threshold for 5 consecutive settlement days. See 17 C.F.R. § 242.203.

purchasing securities of like kind and quantity in the market, with some exceptions.[6] As we discuss in this report, in 2008, SEC took further actions, which consisted of two emergency orders and an interim final temporary rule (temporary rule), to address the potential for manipulative naked short selling because of concerns about increasing market volatility.

This report addresses your interest in the implementation and enforcement of Regulation SHO and subsequent regulatory actions and their effectiveness in curbing FTD and the potential for manipulative naked short selling. Specifically, this report

1. provides an overview of the actions SEC has taken to address potential manipulative naked short selling and FTD, including Regulation SHO and the recent emergency orders, and the factors SEC considered in taking them;

2. discusses the potential impact of Regulation SHO on FTD in threshold and nonthreshold securities using trend analysis;

3. discusses regulatory, industry, and other market participants' views on the effectiveness of Regulation SHO and the recent emergency orders in curbing the potential for manipulative naked short selling;

4. analyzes SEC and self-regulatory organization (SRO) efforts to enforce industry compliance with Regulation SHO and detect manipulative naked short selling; and

5. discusses industry experience with the implementation of the new and enhanced delivery requirements.

To address the first objective, we reviewed the regulatory actions SEC has taken to address naked short selling and FTD, including Regulation SHO, amendments to the regulation, the recent emergency orders, and the temporary rule relating to the delivery of equity securities. We also conducted interviews with staff from SEC's Division of Trading and Markets (Trading and Markets) to obtain information on the factors SEC considered in taking these actions.[7] To address the second objective, we

[6]Specifically, the close-out requirement is triggered when the FTD (which occurs on T+3) persists for 10 consecutive days, or until T+13. Broker-dealers must close out the FTD by the next morning, or by T+14.

[7]Trading and Markets was known as the Division of Market Regulation until November 2007.

analyzed publicly available FTD data produced by the National Securities Clearing Corporation (NSCC), a clearing agency subsidiary of DTCC and the daily threshold lists published by the SROs. We analyzed these data to identify FTD trends in the threshold securities and across the market. We determined these data were reliable for our purposes. To make this determination, we reviewed a 2005 Office of Compliance and Inspections and Examinations (OCIE) examination that, in part, assessed NSCC's processes for generating reports that are used to provide daily FTD data to SEC and the equities SROs. We also employed our own data reliability tests. For example, we reviewed the data for missing values and outliers as well as the accuracy of pricing information. In addition, we reviewed analyses of these data that SEC's Office of Economic Analysis (OEA) conducted. To address the third objective, we reviewed and analyzed the requirements of Regulation SHO, the relevant recent emergency orders, and the temporary rule and an OEA study. We also conducted interviews with staffs from Trading and Markets, OCIE, OEA, SEC's Division of Enforcement (Enforcement), and the Financial Industry Regulatory Authority, Inc. (FINRA); broker-dealers and two trade associations representing broker-dealers; an issuer, and a trade association representing issuers; securities lenders, and a trade association representing securities lenders; securities lending consultants; an investor; legal and subject area experts; and other market observers.

To address the fourth objective, we reviewed a 2005 joint sweep examination that OCIE and the SROs conducted. In a sweep examination, OCIE probes specific activities of a sample of broker-dealers to identify emerging compliance problems in order that they may be remedied before becoming too severe or systemic. We reviewed a sample of subsequent OCIE and FINRA examinations, a 2006 sweep examination that the Chicago Board Options Exchange (CBOE) conducted of its option market making members, and FINRA examination guidance, and we interviewed OCIE, FINRA, and CBOE staffs. We obtained data from FINRA and CBOE on the numbers of Regulation SHO-related examinations conducted since the regulation became effective and the number of examinations that resulted in Regulation SHO deficiencies. To address the fifth objective, we obtained and summarized comment letters submitted to SEC on the temporary rule. We interviewed broker-dealers, a trade association representing broker-dealers, and staffs from Trading and Markets and an SRO.

We conducted this performance audit from March 2008 through May 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain

sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Appendix I provides a more detailed description of our scope and methodology.

Results in Brief

A primary purpose of Regulation SHO is to curb the potential for manipulative naked short selling by addressing those FTD in equity securities that had accumulated to a level SEC considered high enough to potentially affect the market for these securities. Recently, growing concerns about volatile markets and declining investor confidence prompted SEC to take emergency actions in the summer and fall of 2008 to further address FTD and the potential for manipulative naked short selling by issuing both permanent and temporary amendments to Regulation SHO. For example, in July 2008, SEC issued an emergency order to temporarily restrict naked short selling and FTD in the publicly traded securities of 19 large financial firms, with limited exceptions.[8] SEC did not have evidence that manipulative naked short selling was occurring in the securities of these institutions when it issued the order. Rather, SEC issued the order because it was concerned that rumors about the institutions may have fueled market volatility, and that naked short selling could accelerate a price decline in the securities of a firm targeted by any such rumor. In September 2008, SEC took more comprehensive action to curb the potential for manipulative naked short selling when, in consultation with the Board of Governors of the Federal Reserve System (Federal Reserve) and the Department of the Treasury (Treasury Department), SEC issued another emergency order that, among other things, temporarily enhanced close-out requirements on the sale of all equity securities. The September emergency order required broker-dealers to deliver securities resulting from short sales in any equity security (not just threshold securities) by the settlement date (T+3), or if they have FTD on the settlement date, to take action to purchase or borrow securities to close out the FTD by the beginning of regular trading hours the next morning (T+4), with limited exceptions.[9] Broker-dealers who can show that the FTD resulted from a long sale were allowed until the beginning of regular trading hours on T+6 to close out the FTD.[10] Upon expiration of

[8] 73 Fed. Reg. 42379 (July 21, 2008).

[9] 73 Fed. Reg. 54875 (Sept. 23, 2008).

[10] A "long sale" is one in which the seller owns the securities that were sold.

the emergency order, SEC extended these requirements until July 31, 2009, as part of the temporary rule.[11]

Our analysis of FTD data from January 2005 to December 2008 showed that the number of threshold securities initially declined after the implementation of Regulation SHO in January 2005, but increased significantly later, concurrent with the onset and worsening of the financial crisis. The number of threshold securities initially declined by about 45 percent between January 2005 and August 2006, from an average of 423 per month to 231 per month, indicating that Regulation SHO may have had an initial impact of reducing the number of threshold securities soon after the regulation became effective, although other factors may have contributed to this initial decline.[12] After July 2006, the average monthly number of threshold securities began climbing and reached a record high of 582 in July 2008. Staffs from OEA and Trading and Markets said that increased trading volume, volatility, and short interest during this period likely played a role in the increase in threshold securities during this period.[13] Threshold securities declined significantly after SEC issued the July and September emergency orders. While SEC issued the July emergency order at the time that the number of threshold securities reached their record high, it not clear whether this action had a causal effect in the subsequent decline in threshold securities, because only 1 of the 19 firms subject to the order was on the threshold list before the order took effect. OEA officials said that market uncertainty about whether SEC would take additional emergency actions may have affected short selling volume and caused the number of threshold securities to decline, but they did not have conclusive evidence. In contrast, these officials noted that the September emergency order appeared to have had a significant impact on threshold securities, although the sustainability of this trend is yet unclear. By November 2008, the average number of threshold securities had declined to 72. This number temporarily increased to 123 by December 31, 2008, but subsequently declined. By May 5, 2009, there were 68 securities

[11]73 Fed. Reg. 61706 (Oct. 17, 2008).

[12]We found that the overall number of securities across the market with FTD and the level of these FTD appeared to have been declining since at least April 2004—the earliest date we could obtain FTD data—and 8 months before the effective date of the regulation's locate and delivery requirements and continued after their implementation. Regulation SHO may have accelerated this trend with respect to threshold securities.

[13]"Short interest" refers to the total number of shares of a security that has been sold short, but not covered or closed out, and often is used as a proxy for the volume of short selling.

on the threshold list.[14] Our analysis of FTD data showed that the majority of securities on the threshold list graduated from the list in a timely manner, although 80 percent returned to the list at least once. Furthermore, until SEC issued the September emergency order, some threshold securities persisted for extended periods. About 300 unique securities persisted on the threshold list for more than 90 days from January 2005 through December 2008. From May 2005, the first month that a security could have been on the threshold list for more than 90 days, through September 2008, the average daily number of such securities ranged from 12 to 63 per month, but after SEC implemented the September order, they declined to zero.[15] About 50 percent of the remaining threshold securities in December 2008 were exchange-traded funds (ETF).[16] SEC and FINRA staffs believe that structural characteristics related to the creation and redemption of these products may make them more likely to experience FTD and appear on the threshold list.

Some market participants and others (commenters) believe that the current locate and close-out requirements are not sufficient to curb FTD resulting from short sales or to prevent manipulative trading.[17] First, some noted that Regulation SHO does not require the entity on which a broker-dealer relied as a source of available securities on the trade date to have shares available on the settlement date. As a result, these commenters said that broker-dealers or other entities with securities available for borrowing could provide locates for more shares than they have available,

[14]The number of securities with FTD across the market declined significantly after the implementation of the July and September emergency orders that applied the close-out requirements to FTD in all securities.

[15]The persistence of some securities on the threshold list over the review period did not necessarily signify that violations of the close-out provision or manipulative naked short selling were occurring, since securities legitimately could persist for several reasons. For example, FTD in these securities could have been exempt from the close-out rule while the former grandfather and options market maker exceptions were in effect. Additionally, participants could have closed out their FTD in compliance with the close-out requirements of Regulation SHO, but other participants may have created new FTD at the same time, thus keeping the security on the threshold list.

[16]ETF are similar to index funds in that they primarily invest in the securities of companies that are included in a selected market index, but the shares of the ETF are traded on a stock exchange. ETF do not sell individual shares directly to investors and only issue their shares in large blocks known as creation units.

[17]These commenters represented the views of some issuers, an industry trade association of small broker-dealers, and a securities lending consultant that we either spoke with or whose written comments to SEC we reviewed.

which could lead to FTD. These commenters said that SEC should require broker-dealers to borrow securities prior to effecting short sales (preborrow), or at least require sources of securities to set aside (decrement) shares as they are providing locates, to ensure securities are available for settlement. Second, although most FTD resulting from naked short sales must be closed out on T+4, some commenters expressed concern that market manipulation could occur within that time frame. These commenters said that a short seller could still naked short sell without limit, flooding the market with sell orders and manipulating the price of a security downward, as long as the trader covered the short sales with purchases prior to settlement day. To mitigate the potential for this type of manipulation, these commenters also recommended a preborrow requirement. Trading and Markets staff and industry officials said that it is unlikely that broker-dealers provide locates for more shares than they have available, because only a small percentage of locate requests result in short sales.[18] For example, they said that many customers choose not to proceed with the short sale order after obtaining or requesting a locate. Furthermore, they said that because broker-dealers settle transactions in each security on a net basis, the actual settlement obligation is often less than the number of shares sold short, making borrowing unnecessary or necessary only in limited quantities.[19] To better understand industry practices regarding locates, we reviewed several broker-dealer examinations conducted by OCIE. We found that some of these firms practiced decrementing, or some other form of inventory management to help ensure that they did not provide locates for more securities than they could fill on settlement date. Others, however, did not follow these practices. Without such practices in place, it is unclear how these firms can ensure that they are not providing locates in excess of their available supply of securities. Regarding the potential for market manipulation within the T+4 time frame, Trading and Markets and FINRA staffs agreed that it is possible, but said that such manipulation is likely to occur successfully only in those securities that are highly illiquid, thinly traded, or have a relatively low number of total shares outstanding. Trading and

[18]These industry officials represented the views of several broker-dealers and a large industry trade association with whom we spoke.

[19]Most equity trades in the United States are settled on a continuous net basis, meaning that all of a broker-dealer's sales and purchases of a security are netted daily so that the firm either makes a delivery of securities on settlement day, or receives securities on a settlement day. If a broker-dealer effected more purchases than sales of a security on a particular trading day, it would stand to receive securities on settlement day. See appendix II for additional information on the clearance and settlement process.

Markets staff also told us that the costs of a marketwide preborrow requirement to address FTD, manipulative naked short selling, or market manipulation occurring within the T+4 time frame might outweigh any potential benefits, especially considering that the vast majority of trades settle on time. For example, an OEA analysis of the temporary preborrow requirement implemented through the July emergency order and discussions with market participants found that while the July order did reduce FTD in the securities of the 19 firms subject to the order, it also increased borrowing costs, resulted in fewer short sales, and affected liquidity for these securities. However, Trading and Markets staff said that they are continuing to evaluate the appropriateness of a preborrow requirement as the Commission considers whether to finalize the temporary rule.

OCIE and SRO staffs generally categorize Regulation SHO noncompliance as nonsystemic deficiencies. After SEC implemented Regulation SHO, SEC and the SROs quickly took steps to enforce its requirements, first by conducting a joint sweep examination, and later through regular surveillances of FTD data and routine and other compliance examinations. Although these examinations have found a large number of firms with Regulation SHO compliance deficiencies, OCIE and SRO staffs told us these deficiencies generally were not indicative of systemic problems or attempts to manipulate a security. However, OCIE examiners also found that some broker-dealers were facing challenges in determining whether locates were reasonable and were not resulting in FTD. One way a firm may demonstrate that a locate source is reasonable is to have procedures or systems in place to monitor whether the related trades are resulting in FTD. However, according to OCIE examinations, some broker-dealers are not monitoring whether locates result in FTD because firms do not expect that the locate will be the source from which it will obtain shares for settlement. Furthermore, in the prime brokerage arrangement, while different broker-dealers may provide execution and clearance and settlement services and the customer can deliver the securities to the prime broker for settlement, Regulation SHO does not obligate the clearing firm—in this case, the prime broker—to provide trade settlement information to the executing broker. As a result, the executing broker may not know if, at settlement, the prime broker was unable to borrow shares to delivery, and thus not have the information necessary to determine whether it can rely on that customer's locates for future short sale

transactions.[20] In March 2007, staff from Trading and Markets working with the industry had considered revisions to the 1994 Prime Broker Letter to address this information gap. The 1994 Prime Broker Letter provided guidance that laid out the responsibilities of both the executing and prime brokers for trades they executed and settled on behalf of their clients, typically hedge funds.[21] However, Trading and Markets has yet to finalize the draft revised letter. In the absence of the guidance, some firms may continue to be noncompliant with the locate requirement. Furthermore, the perception that this conduct may occur could undermine investor confidence in the markets. Finally, while examinations have detected compliance deficiencies of Regulation SHO, examiners stated that these deficiencies are not necessarily indicative of manipulative naked short selling. Generally speaking, SEC and the SROs also use other techniques, such as electronic market surveillance, to identify potential instances of manipulative naked short selling.

Although generally supportive of SEC's efforts to prevent manipulative naked short selling, some industry officials said that the September emergency order and the temporary rule resulted in certain unintended negative consequences, such as increased market volatility and price spikes. For example, a large industry group submitted data to SEC suggesting that the temporary rule created significant, but temporary, upward pressure on the prices of securities because broker-dealers are required to close out their FTD at the opening of trading on the morning of T+4 or T+6. Industry officials and SRO staff also told us that throughout the implementation of Regulation SHO and the emergency orders, Trading and Markets staff were responsive to some requests for implementation guidance but did not answer other requests or did so only after lengthy delays. For example, it took an extended period of time for one SRO to receive and publish interpretive guidance from Trading and Markets on technical questions the SRO submitted in 2005 about the implementation of Regulation SHO. Staff from this SRO said while they waited for a

[20]"Prime brokerage" is a system developed by full-service broker-dealers to facilitate the clearance and settlement of securities trades for substantial retail and institutional investors that are active market participants. Prime brokerage involves three distinct parties: the prime broker, the executing broker, and the customer. The prime broker is a registered broker-dealer that clears and finances the customer trades executed by one or more other registered broker-dealers (the executing broker) at the behest of the customer.

[21]See 1994 SEC No-Act. LEXIS 466 (Jan. 25, 1994). SEC staff issued the letter to clarify the obligations and responsibilities under the Exchange Act of each of the parties involved in prime brokerage.

response, they could not provide further guidance on its implementation. Furthermore, a large industry group told us that they were unable to obtain answers to multiple questions on the implementation of the temporary rule. Trading and Markets can provide written interpretive guidance (i.e., a formal response) to the SROs and industry through exemptive orders, no-action letters, compliance guides, staff legal bulletins, and answers to frequently asked questions. Although Trading and Markets staff have discretion in determining which SRO and industry requests merit a formal response, SEC does not have formal processes or guidelines on which to base such determinations. SEC's current strategic plan states that regulations should be clearly written, flexible, and relevant and not impose unnecessary financial or reporting burdens. The plan also states that one potential measure for monitoring progress is the length of time taken to respond to no-action letters, exemptive applications, and interpretive requests. The strategic plan also states that to ensure compliance with federal securities laws, SEC should work to enhance the interpretive guidance process so that it meets the needs of staff, the public, and other external stakeholders. Trading and Markets staff said they have not always responded to industry requests for guidance because they believed the provisions of Regulation SHO were clear or because they believed that some of the requests reflected attempts to find loopholes, rather than to seek clarification. Trading and Markets staff also stated that with the temporary rule expiring at the end of July 2009, they have been focusing on reviewing and analyzing the comments for a recommendation for the Commission's consideration. Furthermore, responding to some of the implementation issues related to the temporary rule could have potentially required changes to the temporary rule, something that Trading and Markets told us they are not authorized to make. However, if the Commission does not take final action on this rule until the expiration date, the rule will have been in effect for 10 months. Without timely and clear interpretive guidance from SEC, the SROs may be unable to effectively enforce SEC rules and regulations, and SEC cannot ensure the consistent implementation of the rules and regulations.

This report makes two recommendations to the SEC Chairman. Specifically, the chairman should (1) promptly finalize the draft revised 1994 Prime Broker Letter to address the current information gap in Regulation SHO for prime brokerage arrangements when the temporary rule becomes final and (2) develop a process that allows Commission staff to raise and resolve implementation issues that arise from SEC regulations, including emergency orders and temporary rules, in a timely manner.

We provided a draft of this report to Chairman of the Securities and Exchange Commission, and the agency provided written comments that are reprinted in appendix IV. In its written comments, SEC stated that regarding our first recommendation, it will consider the need to clarify the communications between prime broker-dealers and executing broker-dealers that would facilitate Regulation SHO compliance in connection with its consideration of further action on the temporary rule. Regarding our second recommendation, SEC stated that it is committed to engaging in a deliberative process to develop meaningful regulation of short selling and providing interpretive guidance to the industry to facilitate implementation, as appropriate. SEC also stated that it will evaluate whether there are additional steps that it can take, consistent with the Administrative Procedure Act, to address implementation issues raised by industry.

We provided relevant portions of the draft report to FINRA and CBOE for their review and comment. FINRA, CBOE, and SEC provided technical comments, which we have incorporated into the final report where appropriate.

Background

According to SEC, short selling provides the market with at least two important benefits: market liquidity and pricing efficiency.[22] For example, market professionals, such as market makers (including specialists) may provide liquidity by naked short selling to offset temporary imbalances in the buying and selling interest for securities.[23] Market makers 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.

[22]Although short selling serves useful market purposes and the vast majority of short sales are legal, short selling also may be used to illegally manipulate the prices of securities. Generally speaking, it is prohibited for any person to engage in a series of transactions to create actual or apparent active trading in a security or to depress the price of a security for the purpose of inducing the purchase or sale of the security by others. One example of a manipulative trading strategy using short selling is the "bear raid," in which an equity security is sold short in an effort to drive down the price of the security by creating an imbalance of sell-side interest. Furthermore, unrestricted short selling can exacerbate a declining market in a security by increasing pressure from the sell-side, eliminating bids, and causing a further reduction in the price of a security by creating an appearance that the security price is falling for fundamental reasons.

[23]A "specialist" is a member of a stock exchange, such as the New York Stock Exchange, that performs several functions. Specialists must make a market in the security they trade by displaying their best bid and ask prices to the market during trading hours.

Thus, market makers must sell a security to a buyer even when there are temporary shortages of sellers of that security available in the market. For the purposes of this report, we refer to both market makers and specialists as market makers. Efficient markets require that prices fully reflect all buy and sell interest. Market participants that believe a security is overvalued may engage in short sales to profit from a perceived divergence of prices from economic values. According to SEC, such short sellers contribute to pricing efficiency because their transactions inform the market of their evaluation of the future price performance of the security. This evaluation is reflected in the resulting market price of the security.

Naked short selling may have negative effects on the market, particularly when it results in FTD and those FTD persist for an extended period and represent a significantly large unfulfilled delivery obligation at the clearing agency. Specifically, SEC stated that short sellers that fail to deliver securities on the trade settlement date may face fewer restrictions than if they were required to deliver the securities in a reasonable period. For example, SEC said that short sellers may sometimes intentionally fail to deliver securities to avoid borrowing costs, especially when the costs of borrowing security are high. Furthermore, SEC stated that such sellers could attempt to use this additional freedom to engage in trading activities that deliberately and improperly depress the price of a security. For example, SEC said that short sellers sometimes may intentionally fail to deliver securities in an attempt to manipulatively naked short sell a security. Issuers and investors have raised concerns to SEC in recent years about manipulative naked short selling, particularly in thinly capitalized securities that trade over the counter (OTC).[24] To the extent that large and persistent FTD might indicate manipulative naked short selling, SEC stated that such FTD may undermine the confidence of investors. In turn, investors may be reluctant to commit capital to an issuer that they believe to be subject to such manipulative conduct.

[24]An "OTC security" is a security that is not traded on a formal stock exchange, but instead is traded by broker-dealers that negotiate directly with one another over computer networks and by telephone. In general, a security is traded OTC because the company that issued it is small, making it unable to meet exchange listing requirements. New and small companies are considered to be more vulnerable to manipulative naked short selling than large companies, because they have a small number of total shares outstanding and it is relatively easier to drive down the price by flooding the market with naked short sales. Also, new companies may not have had the time to establish a reputation for themselves in the capital markets, potentially making it easier for manipulative naked short sellers to use rumors to increase the downward pressure on the security.

Due to the volume and value of trading in today's markets, NSCC nets trades and payments among its participants using its Continuous Net Settlement System (CNS System). This is a book-entry accounting system in which each participant's daily purchases and sales of securities, based on trade date, are automatically netted into one long position (right to receive) or one short position (obligation to deliver) for each securities issue purchased or sold. The participant's corresponding payment obligations are similarly netted into one obligation to pay money or into one obligation to receive money. If a member is unable to fulfill its delivery obligation on settlement date, FTD occurs and the CNS System maintains the net short position for that participant until the obligation is fulfilled.[25] As we have previously discussed, while naked short selling may result in FTD, there are other legitimate reasons why FTD may occur. FTD may result from either a long sale or a short sale, and, according to SEC and FINRA, may result from mechanical error or processing delays. For example, processing delays can result from transferring securities in physical certificate, rather than in book-entry form.

SEC oversees broker-dealers primarily through OCIE and Trading and Markets and in conjunction with FINRA and other SROs. FINRA is an SRO with statutory responsibilities to regulate its broker-dealer members. As part of its responsibilities, FINRA conducts examinations of its members to ensure compliance with SRO rules and federal securities laws. OCIE evaluates the quality of FINRA examinations by conducting oversight examinations of broker-dealers recently examined by FINRA as well as through inspections of SROs that review all aspects of the SRO's compliance, examination, and enforcement programs. OCIE also directly assesses broker-dealer compliance with federal securities laws through "special" and "cause" examinations. Special examinations include sweep examinations. OCIE conducts cause examinations when it has reason to believe something is wrong at a particular broker-dealer. Additionally, OCIE conducts examinations of clearing agencies, which are the SROs that clear and settle most securities trades in the United States. Trading and Markets administers and executes the agency's programs relating to the structure and operations of the securities markets. SEC also has delegated authority to Trading and Markets to administer the securities laws affecting broker-dealers and engage in related oversight activities,

[25]See appendix II for additional information on the CNS System and the T+3 settlement cycle.

such as SRO rule filings.[26] Where appropriate, SEC's Enforcement and the SROs' enforcement divisions are responsible for investigating and disciplining broker-dealers regarding violations of securities laws or regulations.

SEC Initially Focused on Large and Persistent FTD in Certain Securities, but Growing Concerns about Investor Confidence Led SEC to Address FTD across the Market

When it initially promulgated Regulation SHO, SEC sought to curb the potential for manipulative naked short selling by imposing (1) uniform requirements on broker-dealers to locate a source of securities available for borrowing and (2) additional delivery requirements on broker-dealers for securities in which a substantial amount of FTD occurred.[27] However, growing concerns about volatile markets and declining investor confidence prompted SEC to take emergency actions in the summer and fall of 2008 to address all FTD in all equity securities by issuing both permanent and temporary amendments to Regulation SHO.

[26]An individual or entity not certain about whether a particular product, service, or action would constitute a violation of the federal securities law also may request a no-action letter from SEC staff. Most no-action letters describe the request; analyze the particular facts and circumstances involved; discuss applicable laws and rules; and, if the staff grant the request for no action, conclude that the SEC staff would not recommend that the Commission take enforcement action against the requester on the basis of the facts and representations described in the individual's or entity's original letter. SEC staff sometimes respond in the form of a no-action letter to requests for clarification of the legality of certain activities.

[27]See 69 Fed. Reg. 48008, 48014-48017 (Aug. 6, 2004). In addition to establishing uniform locate and delivery requirements, Regulation SHO also suspended Commission and SRO short sale price tests in a group of securities as part of a pilot program to evaluate the overall effectiveness and necessity of such restrictions for limiting short sale abuses. These price tests generally allowed an exchange-listed security to be sold short only at a price above the immediately preceding reported price or at the last sale price if it was higher than the last differently reported price. SEC eliminated the price tests in June 2007 after considering the results of the pilot program.

To Address Manipulative Naked Short Selling, SEC Initially Targeted Regulation SHO to Large and Persistent FTD in Certain Equity Securities, with Some Exceptions

The locate and delivery requirements in Regulation SHO, which required compliance beginning in January 2005, prohibited a broker-dealer from accepting a short sale order in any equity security from another person, or effecting a short sale order in any equity security for its own proprietary accounts, unless it first located securities available for borrowing. To satisfy this requirement, the broker-dealer must either borrow the security, enter into an arrangement to borrow the security, or have reasonable grounds to believe the security can be borrowed so that it can be delivered on the settlement date. Executing broker-dealers must obtain and document their source of borrowable stock (a locate) prior to effecting the short sale.[28]

Broker-dealers can demonstrate that they have reasonable grounds to believe a security can be borrowed in time for settlement by directly contacting a source for that security. Industry officials told us that a potential source for securities might include the securities lending desk of their own firm or that of another broker-dealer or the lending agents for large institutional investors, such as mutual funds, pension funds, or insurance companies. Regulation SHO also allows broker-dealers to rely on industry-generated lists of securities that are considered widely available, instead of contacting the source for those securities directly. These lists generally are known as "easy-to-borrow" lists.[29] Regulation SHO also allows broker-dealers to rely on assurances from a customer that the customer can obtain securities from a third party in time to settle the trade (customer-provided locate). Broker-dealers must document compliance with the locate requirement.

Regulation SHO included three exceptions to the locate requirement. First, it excepted market makers from having to obtain a locate when they effect

[28]Before the adoption of Regulation SHO, SROs had rules requiring their members to locate borrowable stock before effecting short sales. For example, the New York Stock Exchange required its member to make a "diligent effort" to borrow the necessary securities to make delivery. NASD rules required its members to make an "affirmative determination" that the member could borrow the securities or otherwise provide for delivery of the securities by settlement date. SEC stated that one of the reasons it proposed Regulation SHO was to provide uniform locate requirements.

[29]Regulation SHO requires that the information used to generate these lists must be less than 24 hours old, and be readily available so that it would be unlikely that a FTD would occur. SEC stated that repeated FTD in securities that are included on an easy-to-borrow list would indicate that reliance on such lists would not satisfy the reasonable grounds standard.

short sales in connection with bona fide market making activities.[30] SEC stated that this exception was necessary because market makers may need to facilitate customer orders in a fast-moving market without possible delays associated with complying with the locate requirement. According to SEC, market makers are unlikely to cause high levels of FTD, because most of them seek a net "flat" position in a security at the end of each day—offsetting short sales of a security with purchases of that security so that they do not have to deliver securities under the CNS System. Second, Regulation SHO allows an exception to the locate requirement when a broker-dealer receives a short sale order from another broker-dealer (introducing broker-dealer). In these cases, the introducing broker-dealer is required to comply with the locate requirement, unless the executing broker-dealer has entered into a contractual agreement to obtain locates on behalf of the introducing broker-dealer. Third, Regulation SHO provides an exception to the locate requirement in those cases where a broker-dealer effects a sale on behalf of a customer that owns a particular security, but through no fault of the customer or broker-dealer, the broker-dealer does not expect that the security will be delivered by the settlement date.[31] An example of this exception would be sales of restricted securities—securities acquired in unregistered, private sales from the issuers through private placement offerings. The sale of such securities often involves processing delays that prevent the customer from obtaining and delivering the securities on time. Since Regulation SHO requires broker-dealers to mark sales as short if the customer does not have possession of the securities at the time of the sale, broker dealers often must mark the sale of restricted securities as short sales, even though the customer owns the securities.

[30]Regulation SHO does not define bona fide market making activities. However, in the adopting release, SEC provided some examples that would indicate that a market maker is not engaged in bona fide market making. For example, SEC said that bona fide market making does not include activity related to speculative selling strategies or investment purposes of the broker-dealer and disproportionate to the usual market making patterns or practices of the broker-dealer in that security. See 69 Fed. Reg. at 48015. SEC later described factors that would characterize bona fide market making, such as whether the market maker incurred any economic or market risk with respect to the securities (e.g., by putting the market maker's own capital at risk to provide continuous two-sided quotes in markets). However, SEC said that determining whether a market maker is engaged in bona fide market making would depend on the facts and circumstances of the particular activity. See SEC Exchange Act Release No. 34-58775 (October 2008).

[31]The "no fault" qualification is described in the original Regulation SHO *Federal Register* release. See 69 Fed. Reg. at 48015.

As we have previously discussed, Regulation SHO requires clearing broker-dealers that have FTD in threshold securities persisting for 10 days after the normal settlement date (T+13) to close out their FTD by purchasing securities of like kind and quantity by the beginning of regular trading hours the next day (T+14).[32] For example, if a clearing broker-dealer has 100 FTD in threshold security XYZ for 13 consecutive days, the participant is required to purchase 100 shares of XYZ by the next day to close out these FTD. Clearing broker-dealers that do not close out their FTD threshold securities by the morning of T+14 are required to preborrow, or arrange to borrow, securities of XYZ before effecting additional short sales for themselves or for any of their customers, until the FTD are closed out. In adopting these close-out requirements, SEC stated that it believed it was addressing those circumstances that warrant action to address the potential negative effects of large and persistent FTD.[33] By narrowly targeting threshold securities, SEC stated that it would not burden the vast majority of securities without similar concerns for settlement. At the time SEC adopted the rule, OEA had calculated that approximately 4 percent of all reporting securities would qualify as threshold securities.[34]

As adopted, Regulation SHO included three exceptions to the close-out requirement. First, the close-out requirement did not apply to any FTD that were established prior to the security becoming a threshold security.[35]

[32]Clearing broker-dealers are responsible for ensuring delivery and receipt of funds and securities from the clearing agency. Some broker-dealers act as both executing and clearing broker-dealers.

[33]69 Fed. Reg. at 48016.

[34]The close-out requirements apply to reporting securities, those registered with SEC under the Securities Act of 1933. Effective in July 2006, SEC approved a NASD rule that applied substantially similar close-out requirements to nonreporting OTC securities. Similar to Regulation SHO, NASD rule 3210 also required clearing firms to close out all FTD in nonreporting threshold securities that have existed for 13 consecutive days. Because regulators do not have accurate information about the total outstanding shares issued in nonreporting securities, NASD defined them as any equity security that is not a reporting security, and for 5 consecutive settlement days, has (1) aggregate FTD of 10,000 shares or more and (2) a reported last sale during normal market hours on that settlement day that would value the aggregate FTD at $50,000 or more. NASDAQ includes nonreporting threshold securities in the daily threshold lists it publishes on behalf of FINRA.

[35]The grandfather exception applied in the following two situations: (1) FTD occurring before January 3, 2005, Regulation SHO's effective date, and (2) FTD established on or after January 3, 2005, but prior to the security appearing on a threshold securities list. See 69 Fed. Reg. at 48018.

SEC included this exception, termed the grandfather exception, because it was concerned about creating volatility through short squeezes if large preexisting FTD had to be closed out quickly after a security became a threshold security.[36] Second, SEC allowed a limited exception for FTD resulting from short sales effected by options market markers to establish or maintain a hedge on options created before the underlying security became a threshold security, as long as the short sales were effected as part of bona fide market making. SEC created this exception to address concerns expressed by market participants that the close-out requirement would affect the liquidity and pricing of options. These market participants had argued that without the ability to hedge their options through short sales, options market makers would cease options trading in securities considered hard to borrow, and thus, prone to FTD—in other words—securities most likely to enter the threshold list.[37] Finally, SEC excepted FTD resulting from sales of customer-owned securities that the broker-dealer did not reasonably expect would be in its possession by the settlement date, such as the restricted securities that we previously discussed. Broker-dealers have 35 days to close out FTD resulting from the sale of these securities.[38]

After Considering Data Showing the Continued Persistence of FTD in Some Securities, SEC Amended Regulation SHO in August 2007 to Eliminate a Grandfathering Exception

After considering data showing that substantial and persistent FTD in a small number of threshold securities were not being closed out due to reliance on the grandfather exception, SEC amended Regulation SHO in August 2007 to eliminate it.[39] At the time it adopted Regulation SHO, the Commission stated that it would monitor its operation to determine whether grandfathered FTD were being cleared under the existing close-out requirement, or whether any further regulatory action was warranted. We reviewed data that SEC used in its deliberations to eliminate the grandfather exception. For example, we found that OEA had estimated that from January 7, 2005, through December 31, 2005, the average daily percentage of grandfathered FTD to total FTD for securities on the

[36]"Short squeeze" refers to the pressure on short sellers to cover their positions as a result of sharp price increases or difficulty in borrowing the security the sellers are short. The rush by short sellers to cover their positions produces additional upward pressure on the price of the security, which then can cause an even greater squeeze.

[37]69 Fed. Reg. at 48018-48019.

[38]69 Fed. Reg. at 48012 n. 26.

[39]See 72 Fed. Reg. 45544 (Aug. 14, 2007). The amendment became effective on October 15, 2007.

threshold list was about 48 percent. Furthermore, in 2005, OCIE conducted several examinations for Regulation SHO compliance that found that some broker-dealers were still carrying a significant amount of FTD in securities that they were not closing out because they were relying on the grandfather provision.

In the 2007 rule amendment, SEC reiterated its concerns regarding the impact that large and persistent FTD can have on the market for a security.[40] SEC also said that some issuers believed that they had suffered unwarranted reputational damage because of investors' negative perceptions about large and persistent FTD in their securities. According to one issuer's comment letter, its investors attributed the issuer's frequent reappearances on the threshold list to manipulative short selling and frequently demanded that the issuer take action to address this issue. SEC stated that any unwarranted reputational damage caused by large and persistent FTD might have an adverse impact on the security's price. We discuss the number of securities that reappeared on the threshold list during the period of our review in greater detail later in this report.

In Response to Increasing Market Volatility, SEC Issued an Emergency Order in July 2008 to Temporarily Restrict Naked Short Selling in the Securities of 19 Firms

Increasing market volatility in the securities of financial institutions of significance prompted SEC to issue an emergency order on July 15, 2008, that temporarily restricted short sales in the publicly traded securities of 19 large financial firms, unless the seller had borrowed, or arranged to borrow, the security prior to effecting the short sale.[41] The order also prohibited any FTD in these securities by requiring that the short seller deliver the security on the settlement date. The order was effective from July 21, 2008, to August 12, 2008. SEC amended the order on July 18, 2008, to except market makers engaged in bona fide market making from the preborrow requirement.[42]

SEC issued the order because it was concerned that rumors about financial institutions of significance in the United States may have fueled market volatility in the securities of some of these institutions. Trading and Markets staff said that SEC's decision to issue the order was

[40]72 Fed. Reg. at 45545-45548.

[41]73 Fed. Reg. 42379 (July 21, 2008).

[42]SEC issued the amendment in response to implementation issues raised by the industry. The amendment also excepted sales of restricted securities from the preborrow and delivery requirements. See 73 Fed. Reg. 42837 (July 23, 2008).

precipitated by the rapid decline and subsequent collapse in the price of the securities of the investment firm Bear Stearns.[43] This event raised concerns at SEC about a type of market manipulation called short and distort (i.e., an individual short sells a particular security and then attempts to drive down its price by spreading false rumors about the company).[44] Although a trader could engage in a short-and-distort scheme without naked short selling, SEC stated it was concerned that naked short selling could accelerate a price decline in the event of a false rumor.

SEC chose the 19 financial firms because it believed that they were particularly susceptible to short-and-distort schemes. Trading and Markets staff said that they did not see evidence of naked short selling or increased FTD in these securities prior to the issuance of the emergency order. Instead, they said that the emergency order was an attempt by the Commission to reassure the investing public that SEC would not allow naked short selling to occur.

Sudden and Unexplained Declines in the Prices of Equity Securities Led SEC to Issue Additional Emergency Orders in September 2008 That Address FTD across the Market

Citing concerns about sudden and unexplained declines in the prices of equity securities generally, SEC, in consultation with the Federal Reserve and the Treasury Department, issued an emergency order on September 17, 2008.[45] This order (1) temporarily enhanced delivery requirements on the sale of all equity securities, (2) implemented an antifraud rule targeted to short sellers that lie about or misrepresent their intention to deliver securities in time for settlement, and (3) eliminated the options market maker exception to Regulation SHO's close-out requirement.[46]

[43]According to the July emergency order, during the week of March 10, 2008, rumors spread about liquidity problems at Bear Stearns that eroded investor confidence in the firm. As the price of Bear Stearns' securities fell, its counterparties became concerned, and a crisis of confidence occurred late in the week. In particular, counterparties to Bear Stearns were unwilling to make secured funding available to Bear Stearns on customary terms.

[44]In April 2008, SEC charged a trader with securities fraud and market manipulation for intentionally disseminating a false rumor concerning the Blackstone Group's acquisition of Alliance Data Systems Corp.

[45]Trading and Markets staff told us that Treasury Department and Federal Reserve officials had held high-level talks with the former SEC Chairman to develop a coordinated federal response to the various crises in the marketplace. In January 2009, the former Chairman resigned, and the new Chairman was sworn in.

[46]73 Fed. Reg. 54875 (Sept. 23, 2008).

First, SEC added a temporary amendment to Regulation SHO through the September order to enhance delivery requirements on sales of all equity securities. The temporary rule requires clearing broker-dealers to deliver securities resulting from any short sale by the settlement date (T+3), or, if they have FTD on the settlement date, to take action to purchase or borrow securities to close out the FTD by no later than the beginning of regular trading hours on T+4. Participants that do not close out their FTD on the morning of T+4 are required to borrow, or arrange to borrow, securities before effecting additional short sales. Clearing broker-dealers that can show that the FTD resulted from a long sale, or a short sale by a market maker engaged in bona fide market making, have until the beginning of trading hours on T+6 to close out the FTD by purchasing securities of like kind and quantity. Upon expiration of the emergency order, SEC adopted these requirements as an interim final temporary rule, with a request for comments, which is set to expire on July 31, 2009.[47]

In issuing the temporary rule, SEC stated it was concerned that the current locate and close-out requirements in Regulation SHO had not gone far enough to reduce FTD and address potential manipulative naked short selling, especially in light of the ongoing instability and lack of investor confidence in the financial markets. SEC also noted that because Regulation SHO's close-out requirement applied only to threshold securities, FTD in nonthreshold securities never had to be closed out. In addition, SEC noted that the current delivery requirement for threshold securities under Regulation SHO and the lack of any delivery requirement for nonthreshold securities enabled FTD to persist for many days beyond the settlement date. SEC stated that the temporary rule was needed to require earlier close outs of FTD so that more sales would settle by settlement date. SEC acknowledged that the temporary rule's delivery requirements may require the close out of some FTD that occur because of ordinary settlement delays and would ordinarily clear up within a few days, but SEC believes that these requirements were necessary to help ensure that all trades in all equity securities settled by settlement date and that FTD would be closed out promptly after being incurred.

The September order also made effective SEC's proposed "naked" short selling antifraud rule. The rule is intended to clearly affirm the liability of individuals who deceive specified individuals about their intention or ability to deliver securities in time for settlement, including individuals

[47]73 Fed. Reg. 61706 (Oct. 17, 2008).

who deceive their broker-dealer about their locate source or ownership of shares and fail to deliver securities by settlement date. Enforcement staff said that a rule highlighting the illegality of these activities would focus the attention of market participants on such activities. This rule does not provide SEC with any additional enforcement powers. Following the expiration of the order, SEC made the amendment permanent.[48]

Third, the September order made effective a proposed rule amendment to eliminate the options market maker exception from Regulation SHO's delivery requirement.[49] SEC had proposed to eliminate this exception in August 2007, based in part on data it had obtained from SROs showing that substantial levels of FTD continued to persist in some threshold securities as a result of this exception.[50] Following the expiration of the order, SEC made the amendment permanent.[51]

SEC issued a second emergency order on September 18, 2008, also in consultation with Federal Reserve and Treasury Department officials, that temporarily restricted all short sales in the publicly traded securities of about 800 financial institutions (short sale ban).[52] In the order, SEC noted its continued concerns regarding recent market conditions, and noted that short selling in the securities of a wider range of financial institutions than those subject to the July emergency order may be causing sudden and excessive fluctuations of the prices of such securities that could threaten fair and orderly markets. The order expired on October 8, 2008.

[48]73 Fed. Reg. 61666 (Oct. 17, 2008).

[49]SEC Exchange Act Release No. 58775 (Oct. 14, 2008).

[50]According to a review conducted by several SROs in May through July, 2006, options market makers claimed 598 exceptions covering 58 threshold securities, for a total of 11,759,799 FTD.

[51]73 Fed. Reg. 61690 (Oct. 17, 2008).

[52]73 Fed. Reg. 55169 (Sept. 24, 2008). SEC later amended the order to provide that the SROs select the financial institutions covered by the order.

The 2008 Emergency Orders Appear to Have Reduced Threshold Securities and FTD from Record Highs, but the Sustainability of This Trend Is Unclear

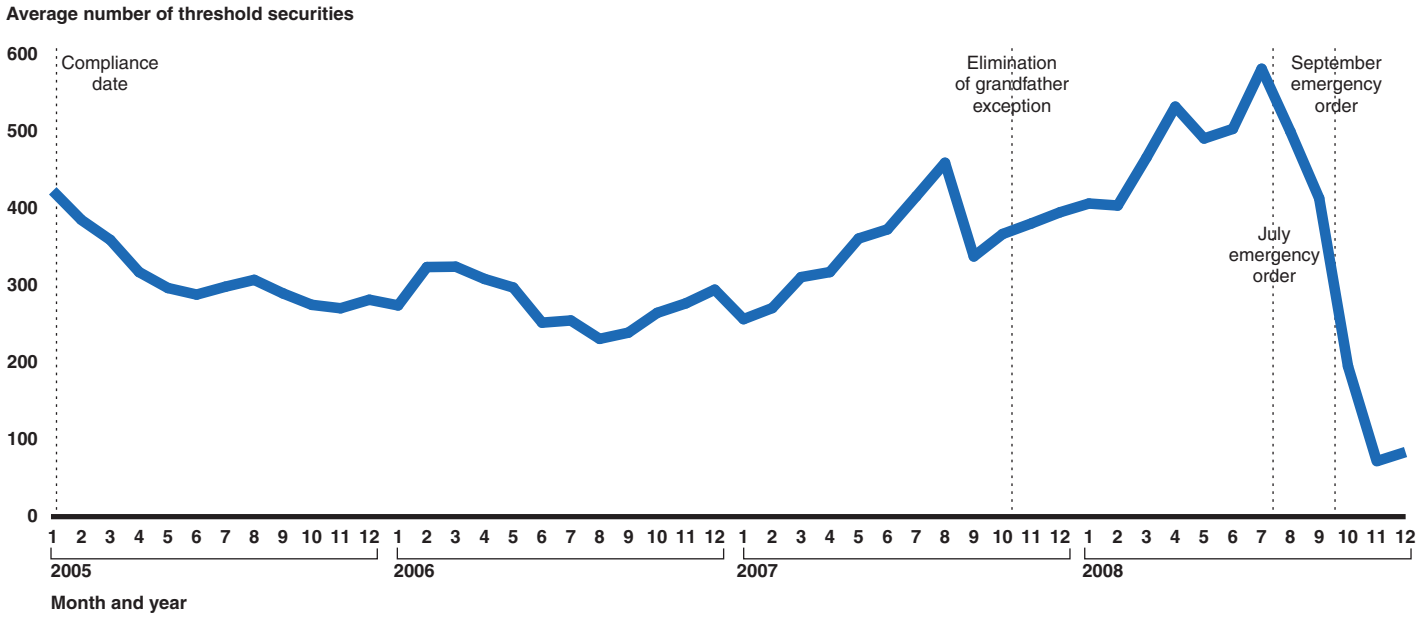
We reviewed trends in threshold securities and their FTD from January 2005 through December 2008 (the review period). These measures showed initial declines soon after the implementation of Regulation SHO, but subsequently increased during 2007, concurrent with increasing turbulence in the markets brought on by the financial crisis. We observed significant declines in threshold securities and their FTD after SEC implemented the July and September 2008 emergency orders, but the sustainability of this trend is unclear.

Threshold Securities Initially Declined after Implementation of Regulation SHO, but They Increased Significantly in 2007 and 2008 as the Financial Crisis Worsened

We reviewed trends in threshold securities and their FTD between January 2005 and December 2008. Although definitive conclusions cannot be drawn from simple trend analysis, we had difficulty discerning an intermediate impact of Regulation SHO on these measures. Figure 1 shows the average number of securities on the threshold list, by month, over the review period. Although subject to volatility from month to month, the average monthly number of threshold securities declined from 423 to 231, or by about 45 percent from January 2005 through August 2006. This decline was most pronounced in the first 6 months after the regulation became effective, and particularly in the first month, when the number of securities declined from 529 on January 10, 2005 (the date the SROs published the first threshold list), to 414 by January 31, 2005. After July 2006, however, the average monthly number of threshold securities per month began to trend upward, reaching a record high of 582 for the review period in July 2008. This upward trend corresponds to several indicators of the severity of the current financial crisis, including several bankruptcies involving mortgage lenders starting in December 2006; announcements by the ratings agencies of downgrades and reviews for potential downgrade of mortgage-related assets starting in June 2007; and negative announcements by Bear Stearns beginning in June 2007 and its subsequent merger to avoid collapse in March of 2008, among others. Caution should be used in interpreting the trends in threshold FTD,

especially since we do not have an appropriate measure of FTD prior to Regulation SHO.[53]

Figure 1: Average Number of Threshold Securities, by Month, from January 2005 through December 2008



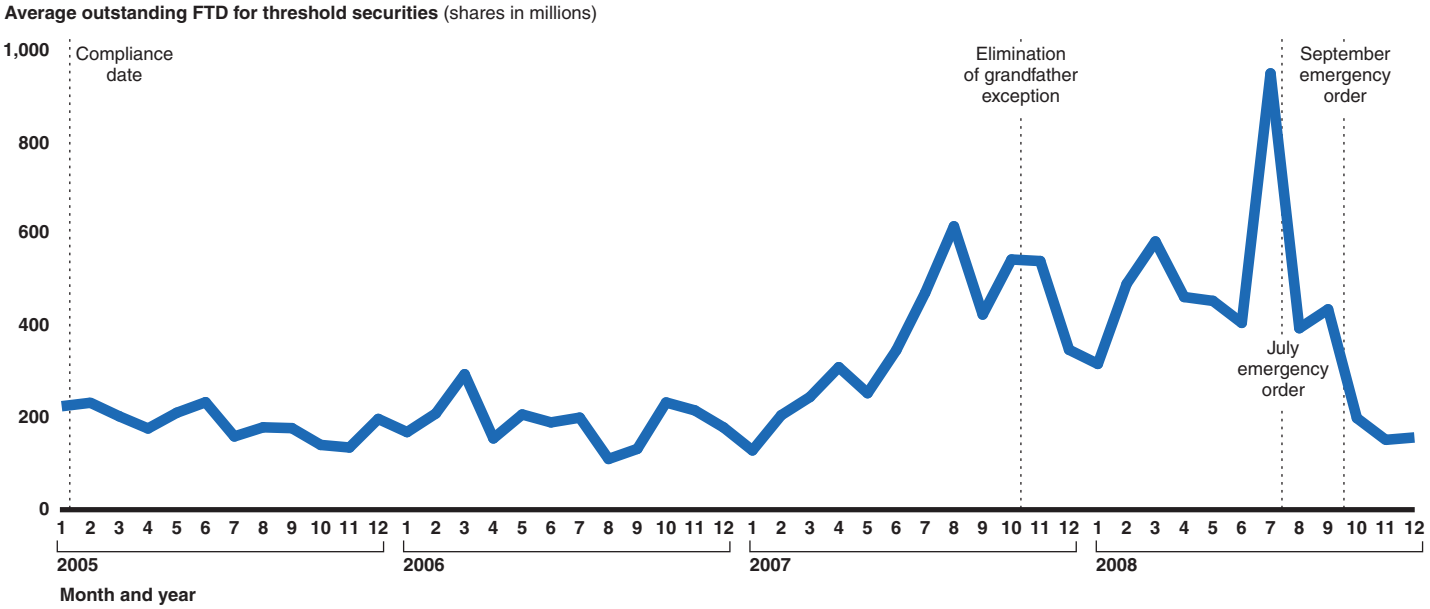
Sources: SEC (data); GAO (analysis).

Average outstanding FTD per month in these securities also declined from 218.5 million to 104.2 million, or 52 percent, between January 2005 and August 2006 (fig. 2). However, there was greater volatility from month to month in this figure, and the direction and magnitude of the change are

[53]Because Regulation SHO created a class of securities designated as threshold securities, our trend analysis is restricted to the period after its implementation in January 2005. On the other hand, OEA applied the rule to historical data and generated an unofficial threshold list for the April 1, 2004, through December 31, 2004, period. In comparing this period with the January 1, 2005, through May 1, 2006, period, OEA found that the average daily number of securities on the threshold list declined 38 percent. This approach has certain limitations. For example, if the 189 days that make up the prerule period is abnormal, we could attribute changes to Regulation SHO that merely reflect a return to normalcy. Additional data prior to April 1, 2004, and a methodology that controls for existing trends in the data and a potential "regression to the mean" effect would provide a more valid assessment of the effectiveness of Regulation SHO in curbing large and persistent FTD. Moreover, neither the OEA methodology nor the trend analysis that we employ for threshold securities controls for other important factors that can also influence FTD, such as volume, volatility, or short interest.

highly sensitive to the start and end points selected.[54] After July 2006, outstanding FTD increased considerably. As we discuss in the text that follows, an increase in threshold security FTD does not necessarily imply ineffectiveness since it is difficult to determine what would have happened in the absence of Regulation SHO.

Figure 2: Average Outstanding FTD for Threshold Securities, by Month, from January 2005 through December 2008



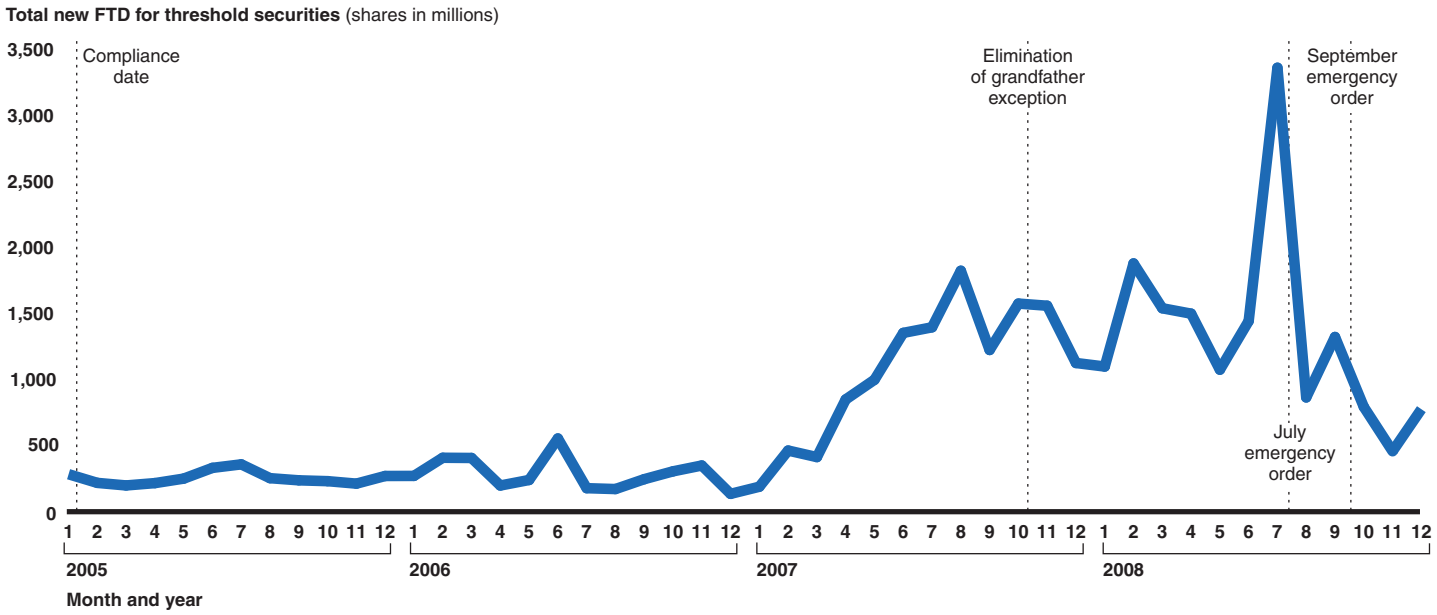
Sources: SEC (data); GAO (analysis).

We also generated the total number of new FTD, per month, in threshold securities over the review period (fig. 3). New FTD are the number of FTD that occur each day. Total new FTD from January 2005 through August 2006 declined by about 43 percent, from 264.3 million to 151.7 million, again subject to considerable volatility. For example, when we measured the difference in new FTD from January 2005 through June 2006, we found that new FTD increased 103 percent, to 535.3 million. This was largely due

[54]See appendix III for FTD trends in threshold securities by individual market.

to a significant increase in new FTD in June 2006.[55] This measure also began to increase in 2007.

Figure 3: Total New FTD for Threshold Securities, by Month, from January 2005 through December 2008



Sources: SEC (data); GAO (analysis).

The initial decline in threshold securities, particularly in the first few months of 2005, may indicate that Regulation SHO had some impact on reducing the number of threshold securities soon after the regulation became effective. However, other market factors also may have contributed to this initial decline. We found that the overall level of FTD across the market appeared to have been declining since at least April 2004 (the earliest date we could obtain FTD data), almost 8 months before the effective date of Regulation SHO's locate and delivery requirements,

[55]The new FTDs during the month were related to 2 OTC securities that accounted for 409 million shares of the total. Without these 2 securities, new FTD would have totaled 126 million shares, a decrease of 94 million from May 2006.

and continued after the adoption and implementation of Regulation SHO.[56] Regulation SHO may have accelerated this trend for the threshold securities, and it is possible that a portion of this decline can be attributed to an early impact of Regulation SHO through an announcement effect.[57]

The subsequent increase in threshold securities, outstanding FTD, and new FTD culminated in record highs for the review period in July 2008. It is unclear whether the number of threshold securities and their FTD would have increased further in the absence of Regulation SHO. We note that Regulation SHO did not intend to prohibit FTD in threshold securities. Rather, it was intended to address FTD once they had accumulated to a substantial level and persisted for 13 consecutive days. Moreover, SEC also intended for the locate requirement to limit naked short selling by better ensuring that broker-dealers that effect short sales have a source of securities they can borrow in time for settlement. If Regulation SHO acted to curb FTD resulting from short sales, we would generally expect to see declines in new FTD. Our data, however, indicate overall increases in new FTD during 2007 and up until July 2008, subject to considerable volatility.

As we have previously discussed, SEC eliminated the grandfather exception in August 2007 after data showed that persistent FTD in some threshold securities were due to reliance on this exception. Our data show that despite the elimination of this exception, threshold securities and their FTD levels continued to increase. OEA examined FTD before and after the elimination of the grandfather exception in the threshold securities to determine the impact of its removal. According to OEA, FTD shifted from nonoptionable to optionable securities after the elimination of the grandfather exception. OEA staff said that one explanation of these results could be short sellers that previously failed to deliver in the equity market moved to the options market, where option market makers still

[56]Given that we had some marketwide FTD data predating Regulation SHO, we also conducted an econometric analysis to assess the impact of Regulation SHO on new FTD, outstanding FTD, and fail positions by controlling for factors thought to influence FTD, including trading volume, volatility, market performance, and short interest. We did not find any evidence that the regulation had a significant impact on any of these measures until SEC implemented the September emergency order and related temporary rule in 2008.

[57]SEC adopted Regulation SHO in August 2004, which effectively provides an announcement date, although it is difficult to know whether short sellers would react by beginning to adhere to the new rules early or by aggressively taking advantage of the temporary opportunities under the less restrictive regime. For this reason and the concerns that we have previously discussed, the April 2004 through December 2004 period may not provide an ideal baseline to judge the effectiveness of the rule.

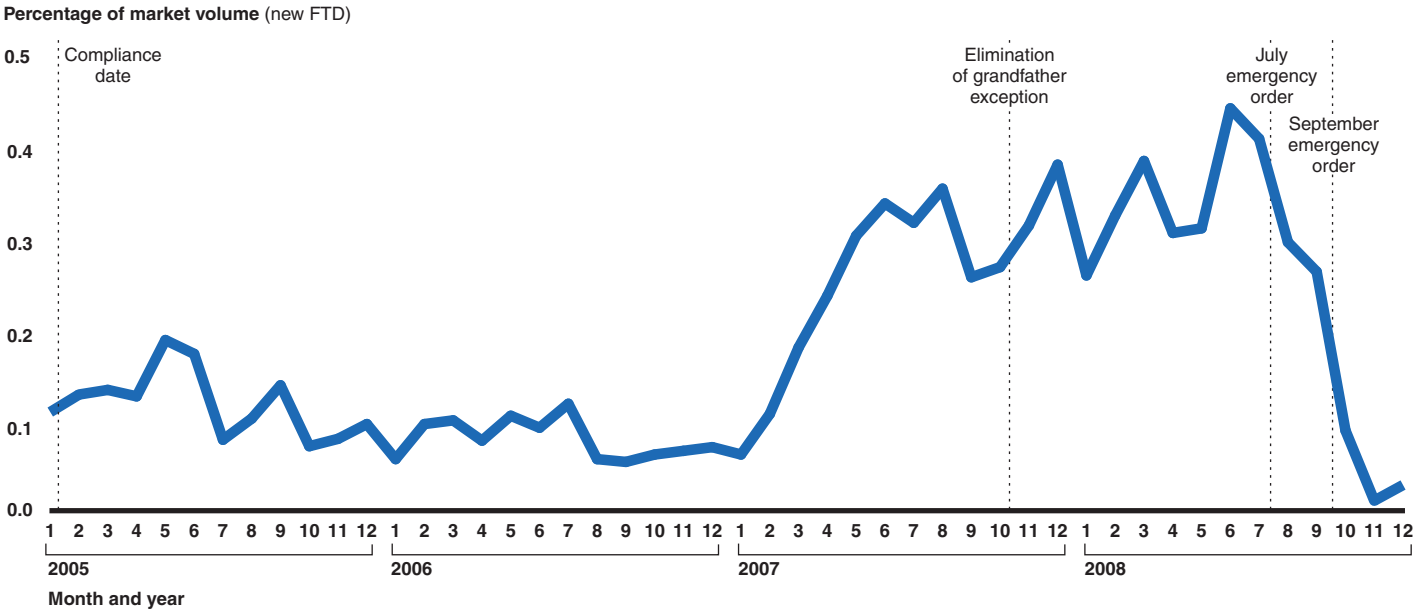
had an exception to the close-out requirement, to establish a synthetic short position.[58] In proposing to eliminate the options market maker exception, SEC analyzed 2006 data and found that some threshold securities were persisting on the threshold list due to option market makers claiming an exception to the close-out requirement. However, CBOE examiners said that by the time SEC eliminated the options market maker exception, it was their understanding that option market makers may have modified their hedging strategies and stopped relying on the exception. They explained that, since SEC began seeking comments on eliminating the exception in July 2006, options market makers had anticipated that SEC would eventually eliminate the exception.

OEA staff said that changes in FTD may be influenced also by factors other than Regulation SHO, such as changes in the mix of securities being traded. For example, they noted that the mix of securities with FTD tilted toward higher-priced stocks after the elimination of the grandfather exception (higher-priced stocks also tend to be optionable stocks), reflecting the financial sector and other industries undergoing turbulence at that time. OEA and Trading and Markets staffs said that changes in market conditions, including overall increases in trading volume, volatility, and short interest, were also likely factors contributing to the increase in FTD. According to these staff, increases in trading volume and volatility are likely to correlate with increases in FTD because the higher the volume of trades, the more likely errors and other processing delays will occur.[59] To the extent that FTD are due to errors or other processing delays, we would expect to see an increase in FTD proportional to an increase in trading volume. In figure 4, we show that the upward trend in FTD for NYSE, NASDAQ, and Amex threshold securities persisted even when expressed as a percentage of market volume. Thus, increased trading volume may not entirely explain the increase in FTD for threshold securities.

[58]According to the Forbes Financial Glossary, a synthetic is a customized hybrid instrument created by blending an underlying price on a cash instrument with the price of a derivative instrument. For example, a synthetic stock can be created by purchasing a call option and simultaneously selling a put option on the same stock. A synthetic short position benefits from the decline of a security's price in the same way that directly selling the stock short would benefit. Additionally, the options market maker typically will sell the stock (long or short, depending on the market maker's position) to hedge the long synthetic position it established in the trade with the short seller.

[59]FTD data generated by NSCC include FTD resulting from long and short sales, but do not distinguish between the two types of sales. Therefore, we cannot determine the cause of FTD from these data.

Figure 4: New FTD for NYSE, NASDAQ, and Amex Threshold Securities as a Percentage of Market Volume from January 2005 through December 2008

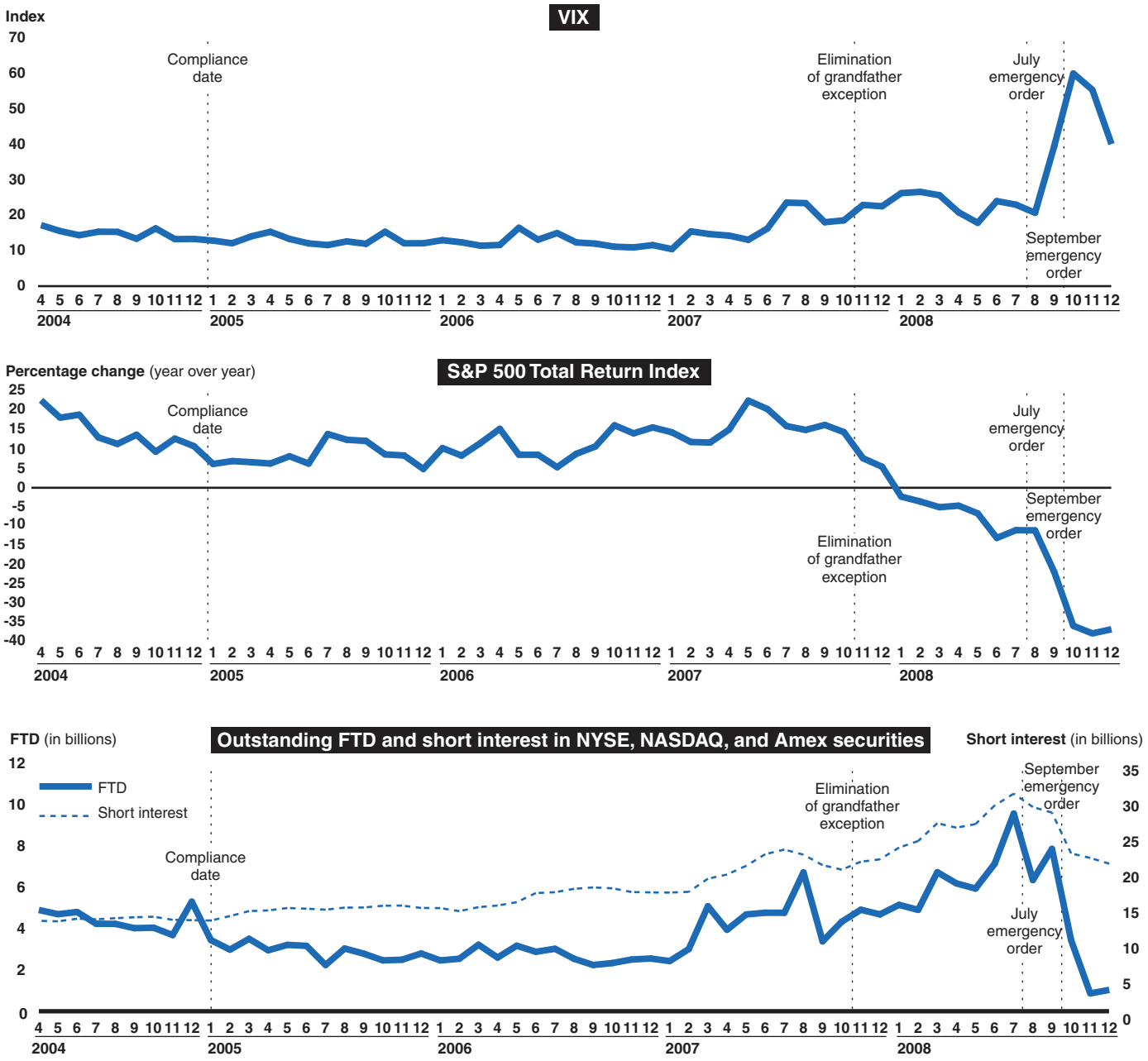


Sources: SEC and FINRA (data); GAO (analysis).

Figure 5 compares trends in volatility, market performance, and short interest with the trends in FTD outstanding across NYSE, NASDAQ, and Amex securities over the review period. The first graphic in figure 5 shows market volatility, as measured by changes in the CBOE Volatility Index (VIX), beginning to trend upward by January 2007.[60] We measured market performance using the S&P 500 Total Return Index (second graphic), and we use short interest—the total number of shares of a security that have been sold short, but not yet covered or closed out—as a proxy for the volume of short selling occurring in the market (third graphic). We expected declining market performance during 2007 and 2008 to correlate with an increase in short interest as market sentiment declined. The third graphic shows that after January 2007, short interest highly correlated with FTD, suggesting that increased short selling activity partially explains the rise in FTD. In particular, the July 2008 high in FTD correlated closely with the peak in short interest over the review period.

[60]VIX is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.

Figure 5: VIX; S&P 500 Total Return Index; and Outstanding FTD and Short Interest in NYSE, NASDAQ, and Amex Securities, from April 2004 through December 2008



Sources: Yahoo! Finance, Global Insight, NYSE, NASDAQ, Amex, and SEC (data); GAO (analysis).

The strong correlation between short interest and FTD suggests that the effectiveness of the locate requirement during this period of market turbulence may have been limited. OEA staff told us that a significant increase in short selling may result in increased FTD as the current processes for locating and obtaining securities may be temporarily overwhelmed. Furthermore, they said that as short interest increases, more securities— particularly those that are less liquid—face a binding borrowing constraint. As a result, borrowing becomes more difficult for more securities, potentially resulting in more FTD.[61] Other factors may also have contributed to the increased number of threshold securities and FTD observed during this period. For example, OEA staff noted the increasing presence of ETFs on the threshold list during this period. We discuss ETFs in greater detail later in this report. Furthermore, industry officials with whom we spoke also said that several threshold securities had ceased trading or were trading at very low prices, making it difficult to resolve any FTD in those securities.

After reaching a high on July 17, 2008, the number of threshold securities and their FTD began to decline. OEA staff pointed to the corresponding decline in short interest as one potential factor. While the SEC's emergency order restricting naked short selling in the securities of 19 large financial firms was issued about the same time (July 15, 2008), OEA staff said that they do not know to what extent the order was responsible for the subsequent decline in threshold securities and their FTD. Only 1 of the 19 firms that were subject to the order was on the threshold list before the order went into effect, and the other securities had low FTD levels. However, these staff said that market uncertainty about whether SEC would take additional emergency actions may have affected the amount of short selling in which the market engaged.

OEA staff said that the September emergency orders—which eliminated the options market makers exception, imposed stricter close-out requirements on FTD in all equity securities, and temporarily banned short selling in the securities of financial firms—had a significant impact on the number of threshold securities and their FTD levels. Our data show that the number of threshold securities continued to decline after the September 2008 emergency orders became effective. Although the

[61]We found evidence of a positive and statistically significant relationship between short interest and failed positions, as well as new FTD, even after controlling for a number of other important factors.

elimination of the options market maker exception and the provisions of the temporary rule were not fully in effect until mid-November when compliance grace periods expired, the average number of threshold securities declined to 72 in November—the lowest number during our review period since the effective date of Regulation SHO. The number of threshold securities temporarily increased to 123 by December 31, 2008, but subsequently declined. By May 5, 2009, there were 68 securities on the threshold list.

Similarly, outstanding FTD and total new FTD in threshold securities also continued to decline after the September 2008 emergency order, although these declines had slowed by the end of 2008, when the level of outstanding FTD had declined to slightly below their January 2005 level. Total new FTD also declined, but by the end of 2008 were still above their January 2005 level. One explanation for continued outstanding FTD may be that the enhanced delivery requirements of the temporary rule apply only to FTD from trades that occurred after the September emergency order became effective on September 18, 2008. Preexisting FTD in any equity security do not have be closed out, unless the security enters the threshold list. In that case, the close out provision for threshold securities applies, and the clearing broker-dealer has 13 consecutive days to close out the FTD. As a result, outstanding FTD may be due to new securities entering the threshold list. We discuss characteristics of the remaining threshold securities later in this section of our report. Furthermore, while the temporary rule imposes close-out requirements on FTD in all equity securities, it does not prohibit them from occurring. Levels of new FTD can continue to fluctuate, although the overall decline since the September 2008 emergency order suggests that the close-out requirements of the temporary rule have curbed the number of threshold securities and new FTD in these securities.[62]

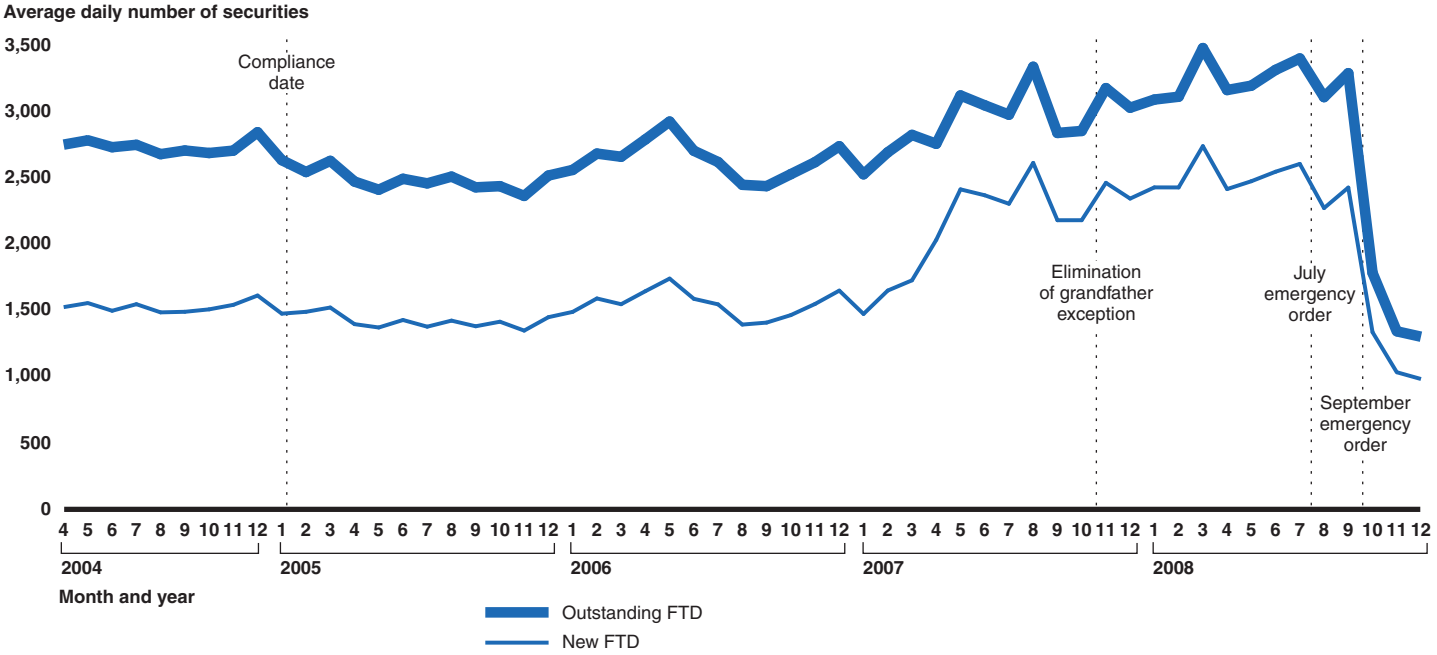
Similar to Threshold Securities, FTD across the Market Showed a Noticeable Decline after the 2008 Emergency Orders

Figure 6 shows the number of equity securities across the market with outstanding FTD and those with new FTD over the review period. As with the threshold securities, the number of these securities began to decline after the July order, concurrent with the decline in short interest, and continued to decline after the implementation of the September emergency order. As we have previously discussed, the close-out requirements of the temporary rule applied to FTD resulting from trades in

[62]Post-December 2008 data were not available at the time of our analysis.

any equity security, not just threshold securities. Most notably, we found that the gap between securities with outstanding FTD and those with new FTD narrowed considerably by December 2008, again suggesting that the close-out requirements were resulting in more prompt close outs. The overall decline in securities with new FTD also suggests the new requirements may be having the effect of curbing new FTD.

Figure 6: Average Daily Number of Securities with Outstanding and New FTD for All Securities, by Month, from April 2004 through December 2008



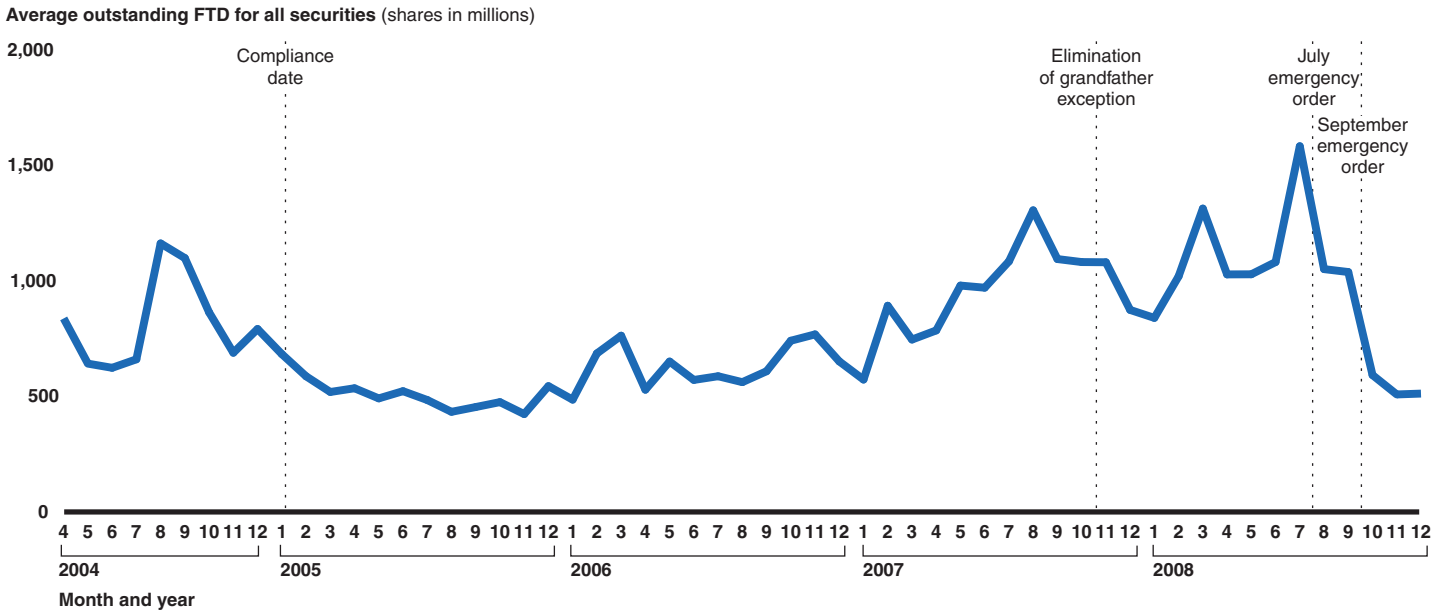
Sources: SEC (data); GAO (analysis).

Note: Prior to September 16, 2008, SEC received FTD data on equity securities with aggregate FTD of 10,000 or more. After this date, SEC began receiving data on all FTD in every equity security. For a consistent comparison, our sample includes securities with aggregate FTD of 10,000 or more for the entire review period.

Figure 7 shows the monthly average outstanding FTD for all securities, and indicates a similar declining trend in threshold securities after July 2008. By the end of 2008, outstanding FTD did not appear to have declined below the earlier low point (late-2005). As we have previously discussed, FTD existing prior to the effective date of the September emergency order do not have to be closed out, unless the security enters the threshold list. In addition, although the temporary rule appeared to have curbed the number of securities with new FTD by the end of 2008, it does not prohibit new FTD. The potential exists that market events, such as increased

trading volume or short interest, could again lead to increased FTD. It remains to be seen whether the stricter close-out requirements are having the effect of encouraging improvements in locating and delivery processes that would help mitigate increases in new FTD under such circumstances.

Figure 7: Average Outstanding FTD for All Securities, by Month, from April 2004 through December 2008



Sources: SEC (data); GAO (analysis).

Note: Prior to September 16, 2008, SEC received FTD data on equity securities with aggregate FTD of 10,000 or more. After this date, SEC began receiving data on all FTD in every equity security. For a consistent comparison, our sample includes securities with aggregate FTD of 10,000 or more for the entire review period.

Although the Majority of Threshold Securities Graduated from the List in a Timely Manner, Some Securities Persisted for Extended Periods

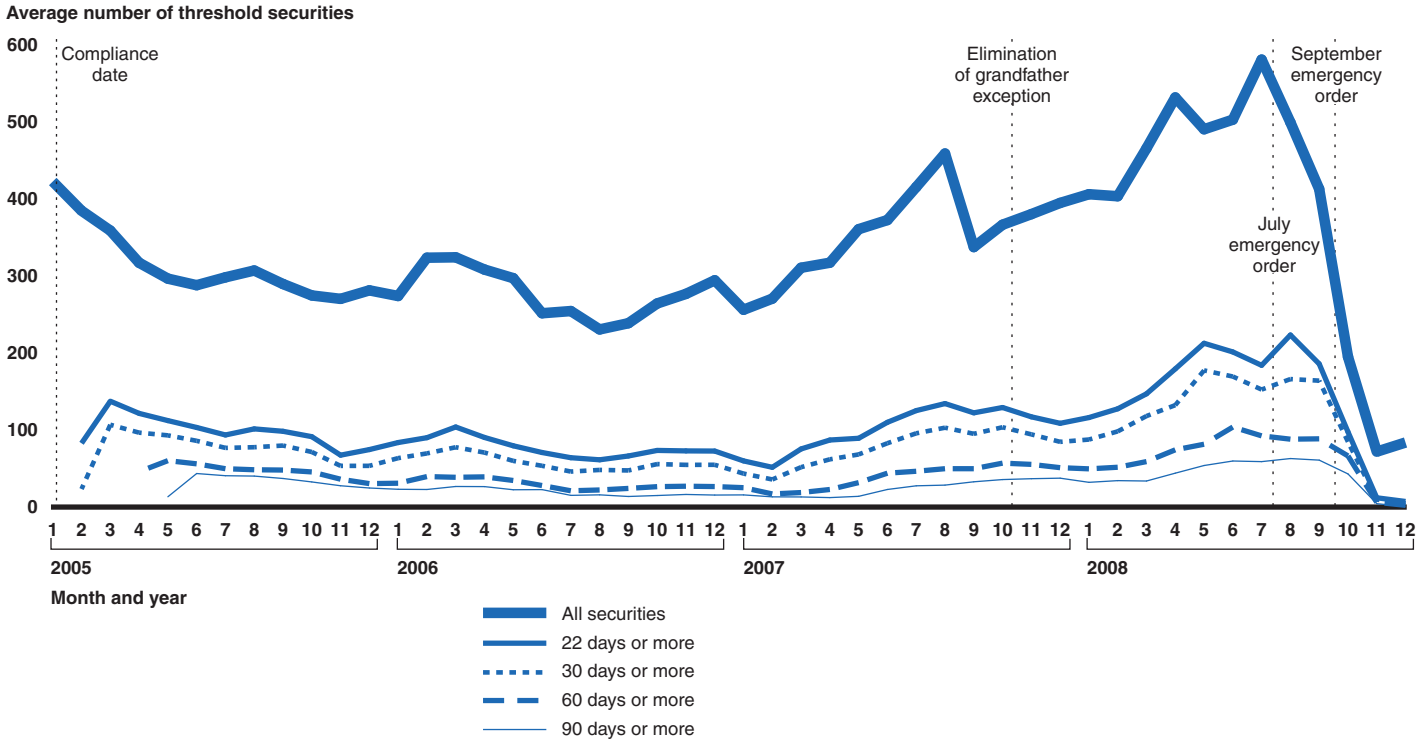
Our review of FTD data showed that the majority of threshold securities "graduated" from the threshold list in a timely manner over the review period, although most returned to the threshold list at least once. Furthermore, until the September emergency order became effective, some threshold securities persisted on the list for extended periods. A majority of the threshold securities (83 percent) graduated from the list within 22 days, the earliest we expected given the implementation of the close-out requirement, and many graduated sooner—25 percent within

6 days.[63] The timely graduation of threshold securities, in most instances, indicates that the regulation worked as intended to reduce FTD to below the threshold level once securities appeared on the threshold list. However, in many instances, this effect was not permanent, as FTD in these securities eventually increased again. From January 10, 2005, the day the first threshold list was published, until December 31, 2008, about 21,400 securities graduated from the threshold list. Of these securities, about 17,000, or 80 percent, returned to the threshold list at least once, and about 1,200, or 6 percent, returned to the list more than 10 times.

In addition to showing the average monthly number of threshold securities over the review period, figure 8 includes data on the number of days these securities persisted on the threshold list. We found that the average daily number of securities per month that were on the threshold list for 22 days or less ranged from 50 percent (October 2008) to 91 percent (December 2008). However, some securities persisted for considerably longer periods. Figure 8 also indicates the number of securities that persisted on the list for more than 22, 30, 60, and 90 days, respectively, during the review period.

[63]For participants with open FTD in threshold securities, the close-out process must start no later than the beginning of trading on T+14. A closeout begun on T+14 will affect FTD on T+17. For a threshold security to graduate from the threshold list, the level of FTD must be below the trigger level for that security for 5 consecutive days. Thus, for those participants waiting until T+14 to close out their FTD, the earliest we would expect to see securities graduating from the list would be T+22. Participants may also choose to close out their FTD earlier. In that case, the earliest securities could graduate from the threshold list would be 6 days, because Regulation SHO requires that securities remain on the threshold list until their FTD levels are below the threshold trigger for 5 consecutive trading days.

Figure 8: Average Number of Threshold Securities, by Month, and Number of Days on the Threshold List, from January 2005 through December 2008



Sources: SEC (data); GAO (analysis).

Securities legitimately could have persisted on the threshold list during the review period for several reasons:

- FTD in these securities could have been exempt from the close-out requirement under the former grandfather and option market maker exceptions, at least until these exceptions were eliminated. FTD in these securities also could have fallen under the third exception from the Regulation SHO delivery requirement if they resulted from long sales of formerly restricted securities. As we have previously discussed, Regulation SHO allows owners of formerly restricted securities 35 days to complete processing of these securities and deliver them to their clearing broker-dealer.

- Clearing broker-dealers may have closed out their FTD in compliance with Regulation SHO, but as old FTD were cleared up, new ones were created that kept the security on the threshold list.

- Clearing broker-dealers may have been unable to close out their FTD after 13 consecutive settlement days, because, for example, of a lack of liquidity in a specific security. In that case, until the relevant clearing broker-dealer was able to obtain securities and close out its FTD, it would be required to preborrow, or arrange to preborrow, securities before effecting additional short sales.

Examination and enforcement staff at FINRA and SEC told us that until they conduct an examination or inquiry into persistent FTD in a threshold security, they do not know whether they were legitimate (e.g., based on an exception) or whether the firm violated Regulation SHO's delivery requirements in those securities.[64]

We reviewed securities that persisted for more than 90 days over the review period and found they comprised about 300 unique securities. Table 1 shows the number of securities that persisted on the threshold list for more than 90 days, by the number of days. The table reflects a total of 365 because some securities appeared on the list more than once. We found 1 security that persisted on the threshold list for more than 700 consecutive days. For those securities that returned to the threshold list more than once, we found that the total number of days they could persist on the list could be greater. For example, 1 security that returned to the threshold list 5 times persisted for a total of 862 days.

Table 1: Number of Securities on the Threshold List for More Than 90 Consecutive Settlement Days, from January 2005 through December 2008

	Number of consecutive settlement days							
	90-100	101-200	201-300	301-400	401-500	501-600	601-700	701-800
Number of securities appearing on the threshold list for more than 90 days	59	229	44	23	7	2	0	1

Sources: SEC (data); GAO (analysis).

[64]In 2007, the SROs identified multiple options traders that were using an illegal options trading strategy to avoid the close-out requirement of Regulation SHO in threshold stocks. We discuss these cases in greater detail later in this report.

The September emergency order appeared to significantly reduce the ability of securities to persist for extended periods. From May 2005, the first month that a security could be on the threshold list for more than 90 days, through September 2008, the average daily number of securities persisting for more than 90 days ranged from a low of 12 per month (April 2007) to a high of 63 per month (August 2008). Our data showed that the number of such securities did not begin to decline significantly from their record high until after the September order became effective. By the end of 2008, no securities on the threshold list had persisted for more than 90 days.

ETFs Accounted for Half of the Remaining Threshold Securities at the End of 2008

The percentage of ETFs on the threshold list increased over the review period (fig. 9) as the number of these products trading in the financial markets also grew.[65] By December 2008, about 50 percent of the securities remaining on the threshold list were ETFs. Trading and Markets and OEA staffs said that, at this time, they do not believe ETFs are persistently failing due to manipulation, and noted that ETFs are characteristically less prone to manipulation than common stock since the ETF price is based generally on large baskets of underlying securities.[66]

Instead, Trading and Markets, OEA, and FINRA staffs believe that structural characteristics associated with ETFs make them more likely to experience FTD. This is primarily because ETFs can only be created and

[65]According to data compiled by the Investment Company Institute and the Strategic Insight Simfund, the number of ETFs trading at year-end grew from 204 in 2005 to 728 in 2008.

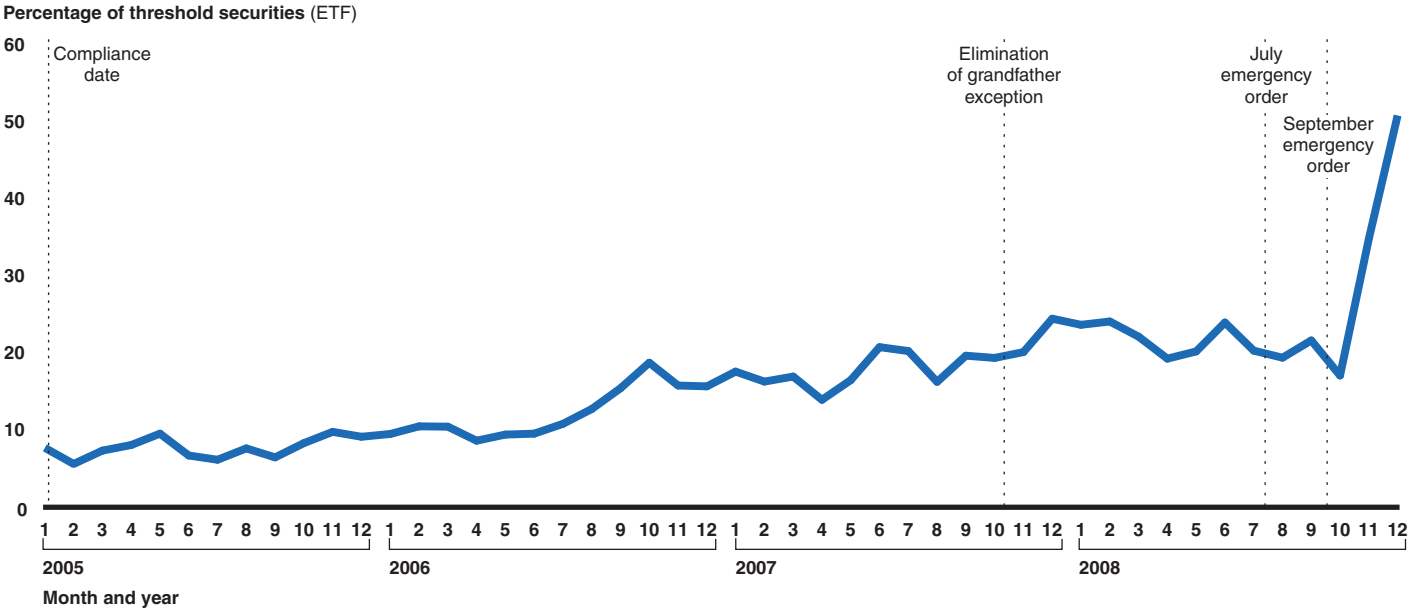
[66]The underlying basket of securities generally reflects the contents of the ETF's portfolio and is equal in value to the aggregate net asset value (NAV) of the ETF shares in the creation unit. According to SEC, the ability of financial institutions to purchase and redeem creation units at each day's NAV creates arbitrage opportunities that may help keep the market price of ETF shares near the NAV per share of the ETF. For example, if ETF shares begin trading on national securities exchanges at a price below the fund's NAV per share, financial institutions can purchase ETF shares in secondary market transactions and, after accumulating enough shares to comprise a creation unit, redeem them from the ETF in exchange for the more valuable securities in the ETF's redemption basket. Those purchases create greater market demand for the ETF shares and, thus, tend to drive up the market price of the shares to a level closer to the NAV. Conversely, if the market price for ETF shares exceeds the NAV per share of the ETF itself, a financial institution can deposit a basket of securities in exchange for the more valuable creation unit of ETF shares, and then sell the individual shares in the market to realize its profit. These sales would increase the supply of ETF shares in the secondary market and, thus, would tend to drive down the price of the ETF shares to a level closer to the NAV of the ETF share.

redeemed in large blocks of shares (e.g., 50,000) called creation units.[67] For example, OEA staff said that, given the costs associated with creating and redeeming units, broker-dealers may have little incentive to create additional units until the number of FTD is at least as great as the creation unit size. As a result, ETFs are more prone to inclusion on the threshold list than other securities. OEA staff said that because many ETFs have a low number of total shares outstanding, FTD in ETFs can easily trigger the 10,000 share FTD and 0.5 percent of total shares outstanding criterion for becoming a threshold security. In addition, the creation unit size may far exceed the 10,000 share FTD trigger level for becoming a threshold security. FINRA staff told us that when newly listed ETFs begin trading, there is uncertainty in the marketplace regarding the level of demand. If demand for the specific ETF exceeds contemporaneous sell-side supply, FINRA staff said that market makers will short sell the ETF pursuant to existing exemptions, causing FTD. However, these staff said that the resulting FTD are typically short term and resolved through the issuance of additional creation units.

Trading and Markets and OEA staffs said that they are continuing to review ETFs to further understand the reasons for FTD in the products, and to monitor any potential changes to ETF products for manipulation or other concerns.

[67]Financial institutions buy creation units with a basket of securities that generally mirrors the ETF's portfolio. After purchasing a creation unit, the institution often splits it up and sells the individual shares on a secondary market. This permits retail investors to purchase and trade the individual shares instead of creation units. ETF shares are not redeemable from the ETF except in creation units. The financial institution acquires (through purchases on national securities exchanges, principal transactions, or private transactions) the number of ETF shares that comprise a creation unit, and redeems the creation unit from the ETF in exchange for a "redemption basket" of securities and other assets.

Figure 9: ETFs as a Percentage of Threshold Securities, by Month, from January 2005 through December 2008



Sources: SEC, Bloomberg, Yahoo! Finance, MSN Money, and Morningstar (data); GAO (analysis).

Some Commenters Contend a Preborrow Requirement Is Needed to Address FTD and Market Manipulation, While SEC Is Still Considering Whether It Would Be Appropriate

Some market participants and others (commenters) expressed concern that under the current locate requirement, broker-dealers with available shares may provide more locates than they have shares available.[68] Furthermore, they said that the current close-out requirements do not address manipulation that can occur within the 3-day settlement period. To mitigate this potential, these commenters advocate requiring short sellers to first borrow securities before effecting their short sales. Trading and Markets and FINRA staffs agreed that market manipulation within the T+3 settlement period is possible. Meanwhile, Trading and Markets staff said that they are still considering whether a preborrow requirement is an appropriate regulatory response.

[68]These commenters represented the views of some issuers, an industry trade association of small broker-dealers, and a securities lending consultant that we either spoke with or whose written comments to SEC we reviewed.

Some Commenters Believe That the Current Locate and Close-out Requirements Are Not Sufficient to Prevent FTD and Market Manipulation

Some commenters believe that the current locate requirement is not sufficient to curb FTD resulting from short sales or prevent manipulative trading. As we have previously discussed, Regulation SHO allows broker-dealers to rely on industry easy-to-borrow lists, instead of directly contacting the source of the securities. According to OCIE and FINRA staffs and industry officials, the industry generally relies on these lists, to satisfy the locate requirement when effecting short-sales in securities considered widely available.[69] For securities that are not on an easy-to-borrow list, the customer or the broker-dealer typically calls the securities lending department of the broker-dealer to determine the availability of the securities for borrowing.[70] However, Regulation SHO does not require the entity on which a broker-dealer relied as a source of available securities to have the securities available on settlement date. Some commenters have expressed concern that unless SEC requires broker-dealers to borrow securities prior to effecting short sales, or at least requires sources of securities to set aside securities as they are providing locates, broker-dealers could provide more locates than they could fill, which could lead to FTD if they are not able to obtain sufficient shares for delivery from another source on settlement day. One securities lending consultant with whom we spoke said that the process of providing locates for hard-to-borrow stocks generally is informal, with locates at times provided verbally. This consultant said that such informal conversations can result in the securities not being available on settlement day if the parties misunderstand the type and amount of securities available. Another consultant in financial services said that because broker-dealers could rely on telephone calls, they may not actually check whether the source was valid.

Although the temporary rule requires most FTD resulting from short sales to be closed out on T+4, several commenters expressed concern that market manipulation could occur within the T+4 time frame. These commenters said that under the current locate and close-out requirements, a trader could still naked short sell a security and cover the sales with purchase orders prior to settlement day. Because the trader does not have to incur the cost of borrowing shares, these commenters said that the trader could naked short sell without limit—thus, flooding the market with

[69]As we have previously discussed, Regulation SHO provides an exception to the locate requirement for market makers engaged in bona fide market making. SEC staff do not know the percentage of short sales that are effected by market makers.

[70]Examinations that we reviewed confirmed these practices.

sell orders to potentially depress the price of the security and realize greater profits. To mitigate this type of market manipulation, the commenters recommended that SEC require broker-dealers to preborrow securities prior to effecting a short sale on behalf of a customer, which they said would eliminate the potential for manipulative short selling within the 3-day settlement period and more generally provide greater assurance that short sales do not result in FTD.

Although Regulatory Staff Said That Overlocating Is Unlikely, Inconsistent Industry Practices in Managing Easy-to-Borrow Lists Could Raise Concerns

Trading and Markets staff said that they have not conducted any empirical studies to assess the effectiveness of the locate requirement for reducing FTD. However, they and industry officials said that overlocating is unlikely to occur because only an estimated 5 percent to 10 percent of locates result in the actual borrowing and delivery of shares. For example, many customers choose not to proceed with the short sale order after obtaining or requesting a locate.[71] Industry officials noted that there is a key difference between a locate, which occurs prior to the short sale being effected, and a borrow, which occurs at settlement. Because broker-dealers settle transactions in each security on a net basis, these officials and the regulators said that the actual settlement obligation is often less than the number of shares sold short, making borrowing unnecessary or necessary only in limited quantities.

Industry officials told us that as a result of the standardization of the locate requirement under Regulation SHO, they have developed policies and procedures that help them to better manage their securities lending operations. More specifically, these officials said that the locate requirement, and the new T+4 close-out requirement for FTD resulting from short sales, has resulted in increased and improved communication with customers prior to effecting a short sale. For example, some industry officials said that as a result of the locate requirement of Regulation SHO, they are denying customers' requests to effect short sales in hard-to-borrow securities because a source of available and sufficient securities cannot be located. They said that the customer has a vested interest in making sure that the broker-dealer can deliver the securities in time for settlement. If securities cannot be borrowed and delivered in time for settlement, the broker-dealer will be required to close out the FTD under

[71]The securities lending consultant told us that because it costs nothing to locate shares, a large amount of locating occurs with the knowledge that borrowing and actual short selling will not take place.

the temporary rule, thus increasing the chance that the customer may be bought-in at a loss or will be required to close out its short position earlier than desired.[72] Industry officials said that, consequently, when customers call the securities lending department to obtain a locate for hard-to-borrow securities, the customer and staff from the securities lending department are more likely to discuss the availability of the security, the cost to borrow it, and the length of time it can be borrowed. Furthermore, industry officials said that broker-dealers also are motivated to manage their inventory effectively to avoid FTD, which otherwise trigger the close-out obligations of the temporary rule.

To better understand industry practices regarding locates, we reviewed several broker-dealer examinations conducted by OCIE that focused on Regulation SHO compliance. We found that four of the five broker-dealers that were examined either generated their own easy-to-borrow lists or used the easy-to-borrow lists of other broker-dealers with which they had stock borrow arrangements, to determine whether a security was widely available for borrowing prior to effecting a short sale.[73] We found that some of these firms decremented their easy-to-borrow lists as they provided locates, or practiced some other form of inventory management to help ensure that they did not provide locates for more securities than they could fill at settlement date. Others, however, did not follow these practices. We note that without such practices in place, it is unclear how these firms could ensure that they are not providing locates in excess of their available supply of securities and thereby limiting the potential for FTD. As we have previously discussed, Regulation SHO does not require firms to decrement their easy-to-borrow lists as they provide locates to their customers or traders, nor does it include definitive criteria regarding what constitutes an easy-to-borrow security other than a reasonableness requirement. Without such criteria, it is unclear how SEC could ensure that firms prepare these lists in a consistent manner and contain an appropriate range of securities that are available for borrowing.

[72]A buy-in occurs when the seller does not deliver the securities on time and the buyer is forced to obtain the securities elsewhere (e.g., by purchasing them in the open market). The costs of conducting the buy-in, including any transaction costs and difference in the price of the security, can be passed to the seller.

[73] The fifth firm used a proprietary system to assist in complying with the short sale locate requirement. This system also required users to call the securities lending desk if the system identified the security as hard to borrow.

Regulators and Industry Officials Said That the Current Locate and Close-out Requirements Make Manipulative Naked Short Selling More Difficult

Although short sellers and broker-dealers could still potentially collude to effect a manipulative short selling scheme, Trading and Markets and FINRA staffs said that under the current locate and close-out requirements, it is less likely traders would effect short sales resulting in persistent FTD. FINRA staff said that this is because the locate and close-out requirements mandate the broker-dealer to settle the trade or to resolve the FTD created when the trade was not settled on time. Customers, on the other hand, do not have any role in the settlement of trades. For example, these staffs said that it would not be very likely that a retail customer, who generally relies on the same broker-dealer to obtain a locate, execute, and settle a trade, could implement a manipulative naked short selling scheme.[74] To do so, FINRA staff said that the broker-dealer would in all likelihood have to collude with the customer and agree to allow a short sale to be effected without a locate being obtained, fail to deliver securities, and keep the FTD open while the customer attempted to fraudulently drive down the price of the security.

Industry officials told us that the customers who are allowed to provide their own locates to executing brokers and arrange for securities to be delivered to the clearing broker-dealer for settlement generally are institutional investors, such as hedge funds. They said that institutional investors may choose to execute and settle the trade with one broker-dealer, or they may choose to execute the trade with one broker-dealer and settle it with another broker-dealer (a prime brokerage arrangement), where the clearing broker-dealer is called a prime broker. When a customer uses a prime broker to clear and settle his trades, the executing broker remains responsible for obtaining a locate, marking the trade long or short, and executing the trade. The prime broker is responsible for delivering securities in time for settlement, whether or not it relies on the customer's source of securities. Therefore, according to FINRA and industry officials, manipulative naked short selling is likely to occur only to the extent that the prime broker agrees to fail to deliver securities on time and keep FTD open. According to industry officials, prime brokers will only look to the customer's source of a locate for delivery if the prime broker cannot otherwise obtain the necessary shares for delivery.

Both Trading and Markets and FINRA staffs said that the preborrow penalty specified in Regulation SHO and the temporary rule provides the

[74]Industry officials told us that they do not accept customer-provided locates from retail investors.

clearing broker-dealer with a strong financial incentive to close out FTD as required by the rules. However, before SEC issued the temporary rule in September 2008, Regulation SHO's close-out requirement applied only to threshold securities (and only after the FTD had been open for 13 consecutive days). Furthermore, FTD in nonthreshold securities never had to be closed out. As a result, under Regulation SHO, FTD resulting from naked short sales could persist for many days. Under the temporary rule, subject to certain exceptions, if a clearing firm is unable to close out FTD resulting from a short sale on the morning of T+4 in any security, or, for FTD resulting from long sales or bona fide market making on T+6, the clearing firm cannot execute additional short sales in that security for any of its customers or its proprietary account, unless it first preborrows (or arranges to borrow) the security. The temporary rule allows the clearing firm to avoid the preborrow penalty to the extent that it can identify any introducing broker-dealer(s) that have contributed to the FTD, by allocating the close-out and preborrow obligations to those broker-dealers. Industry officials and FINRA staff told us that clearing broker-dealers generally do not allocate FTD in this manner.[75] Instead, they told us that clearing broker-dealers may choose to finance the costs of closing out FTD, or preborrow the securities if they cannot, and allocate those costs among their customers. Several clearing broker-dealers told us that they allocate these costs to their customers with open short positions.[76]

Hedge fund officials with whom we spoke said that FTD create friction with prime brokers because the hedge funds rely on the prime brokers to obtain and deliver shares on time. They said that resolving FTD is costly and time-consuming because traders must spend time with the hedge fund's operations group to reconcile the trade. To the extent that the

[75]Officials from several clearing broker-dealers told us that they generally are not able to link a FTD on a particular day for a particular security to an individual trade. As we have previously discussed, clearing broker-dealers settle their trades in individual securities on a net basis. If the clearing broker-dealer does not deliver sufficient securities to NSCC and FTD result, these officials said that they could not identify the particular trade responsible, particularly if the security is a liquid security and there have been many trades that day. These officials noted one exception—generally they can identify an individual trade responsible for FTD if securities are very illiquid. For example, they said that if a particular security had four trades on a particular day, they could more easily determine how the FTD occurred.

[76]An "open short position" refers to a short seller that has executed a short sale, but has not yet purchased securities in the open market to return the borrowed securities used to settle the trade. Until the borrowed securities are returned, the short seller is said to have an open short position.

prime broker cannot identify the customer responsible for the FTD, hedge fund officials said that at times they have been allocated the costs of closing out FTD for which they believe they were not responsible. These officials said that if a hedge fund identifies settlement failures at a particular prime broker, it typically will reduce its activity at that prime broker or stop using it altogether.

Regulators Acknowledge the Potential for Intrasettlement Manipulation, and Are Continuing to Assess Whether a Preborrow Requirement Would Be Appropriate

Trading and Markets and FINRA staffs acknowledged the potential for market manipulation within the T+4 time frame. FINRA officials explained that a fraudulent short selling scheme could occur even in situations where market participants or customers are fully compliant with the locate rule and no FTD develop on settlement day. In such intraday manipulations, the customer or market participant, after having made a valid locate, engages in a pattern of short selling activity during a concentrated period of time, with the specific intent of driving down the price of a stock for a specific period. The customer or market participant then purchases shares after the price decline occurs to cover its short position for a profit. Because the purchase and sale activity nets out to zero, no FTD develop on settlement day as a result of this activity.

Trading and Markets and FINRA staffs said that those securities that are most vulnerable to such short selling abuse would be thinly traded, highly illiquid, and have a relatively low number of total shares outstanding. They said that securities that have many total shares outstanding and are very liquid are more difficult to manipulate, because the trader would have to effect very large and numerous short sale orders to create downward pressure on the price. FINRA staff said that a marketwide preborrow requirement would likely increase the overall costs of short selling, including the costs to effect an intraday market manipulation, but it would not necessarily eliminate this type of misconduct.

Trading and Markets staff also told us that the costs of a marketwide preborrow requirement to address FTD, manipulative naked short selling, or market manipulation occurring within the T+4 time frame might outweigh any potential benefits, especially considering that the vast majority of trades settle on time. After the July emergency order, OEA staff conducted an analysis of the impact of the order to understand the potential economic trade-offs of a preborrow requirement. To address these questions, OEA examined how various measures hypothesized to be

affected by the order evolved over time for the securities of the 19 financial firms subject to the order.[77] OEA then compared the experience of these securities with that of two control samples that were not subject to the order: one control sample consisted of other financial securities, and the other sample consisted of large nonfinancial securities. OEA's results suggested that imposing a preborrow requirement may have had the intended effect of reducing FTD, but also may have resulted in significant costs to short sellers.[78]

First, OEA found that short selling declined more for the securities in the July emergency order than for securities in the two control groups—by almost 9 percent of volume. Second, OEA's analysis showed large, but temporary, initial increases in securities lending rates, as measured by rebate rates, followed by rates still higher than before the order.[79] The rebate rate reflects the portion of interest the lender earns on the borrower's collateral that the lender agrees to pay the borrower. The lower the rebate rate, the higher the securities lending rate.[80] OEA found that rebate rates for these securities over the review period declined by 1.56 percent, from 1.8 percent to 0.24 percent. However, OEA found that the rebate rates dropped significantly in the first day of the July order, on average below negative 1 percent. Rates recovered to above zero before

[77]The emergency order was announced on July 15, 2008; became effective on July 21, 2008; and, after an extension, expired on August 12, 2008. OEA compared the changes in selected market statistics from the period when the order was in effect to a prior period. OEA defined the preorder period from June 12, 2008, to July 11, 2008; the transition period (the week when the order was announced) from July 14, 2008, to July 18, 2008; and the postorder period from July 21, 2008, to August 12, 2008.

[78]Some caution should be used in interpreting these results because the July emergency order was in effect for only 17 days. Moreover, because the special treatment these 19 financial firms received may have been perceived as adverse information, it is difficult to conclude that it was the temporary rules and not investor reaction to perceived differences that caused security lending rates to rise for the 19 firms. Therefore, it is not clear whether the results would be the same if all firms were subject to similar restrictions.

[79]OEA found that securities lending rates over the review period increased around the time that the order went into effect for all groups examined, but the change was only statistically significant for the securities listed in the order.

[80]In a loan contract, the borrower agrees to put up cash collateral of 102 percent to 105 percent of the value of the shares borrowed. The lender agrees to pay the borrower a portion of the interest earned on the collateral. The lender keeps the rest of the interest as payment for supplying the loan. The payment from the lender to the borrower is called a "rebate," and the rate agreed upon is the "rebate rate." In general, the more the lender keeps, the lower the rebate rate. Therefore, lower rebate rates mean higher security lending rates.

the end of the order, but were still well below their preorder levels by the end of the review period.[81]

OEA also found that significant reductions in FTD were associated with the emergency order—the level of FTD in the securities of the 19 firms declined from 2.8 million to 1.0 million during the order, or about 64 percent. New FTD in these securities declined by about 78 percent, from an average of 1.8 million shares per day to 0.4 million shares per day.

OEA concluded that the order appeared to have been effective at reducing and preventing FTD, but it noted that the success came with significant trade-offs, most notably a large increase in lending fees and a large decline in short sales. OEA also noted that the securities included in the order had relatively large market capitalization, traded in a liquid market, and tended to be easy to borrow. Consequently, OEA cautioned that the results may not be fully indicative of how a preborrow requirement might affect markets if applied on a broader scale. Specifically, OEA said that similar requirements imposed on smaller, more illiquid, or hard-to-borrow securities might cause a significantly larger disruption to short selling and to liquidity.

Trading and Markets staff said that they had received feedback from the industry on the impact of the temporary preborrow requirement. The industry commented that the order had a number of unintended consequences, including forcing shares to be borrowed even when they are not needed for delivery, thereby decreasing the liquidity of the securities lending market and resulting in the supply of borrowable shares being allocated to large broker-dealers, leaving smaller broker-dealers in certain situations with less ability to borrow shares to effect short sales. Furthermore, the industry commented that the order impacted the efficient use of capital because firms were forced to commit their own capital to preborrow securities. More specifically, according to an industry trade association, several of its broker-dealer members reported a reduction in the loan liquidity in some of the securities of the 19 firms,

[81]The following two studies in the private sector also reviewed the impact of the July emergency order on the securities lending market: Spitalfields Advisors, "*A Review of the Securities and Exchange Commission's (SEC) Emergency Order Concerning "Naked" Short Selling*" (August 2008); and Sungard Astec Analytics, "*Analysis of the Effect of the SEC's Special Order on the Securities Lending Market*" (Aug. 14, 2008). These studies also found that borrowing costs increased in the securities of the 19 firms subject to the order, and that many firms overborrowed securities to ensure the prompt settlement of short sales.

ranging from an estimated 10 percent to 85 percent, depending on the security. Instead of borrowing securities on a net basis when they were required for the settlement date, the preborrow requirement caused broker-dealers to borrow gross volumes of securities when the securities were located, resulting in significant overborrowing. According to the industry trade association, some firms reported additional balance sheet costs related to financing preborrows, which affected such firms' efficient use of capital. The size of such increases to balance sheet costs varied, with high-end costs of close to $2 billion per day to preborrow securities. These firms reported that increases to balance sheet costs were lower for firms that were arranging to borrow (i.e., hold) rather than to actually preborrow securities prior to effecting the short sales.[82]

As the Commission considers whether to finalize the temporary rule, Trading and Markets staff said that they are continuing to evaluate the appropriateness of a preborrow requirement for addressing FTD and market manipulation related to naked short selling. Separately, SEC is currently considering other measures that are intended to address abusive short selling concerns. In April 2009, SEC voted to propose two approaches to restrictions on short selling. One approach would apply on a marketwide and permanent basis (short sale price restrictions), while the other approach would apply only to a particular security during severe market declines in that security (circuit breaker restrictions).[83] SEC is currently seeking public comments on these two approaches.

[82]While borrowing increased significantly for the securities of the 19 financial firms, it appeared to be temporary. One research firm specializing in securities lending reported that two-thirds of the securities borrowed after the rule was announced were returned to their original owners by August 12, 2008. According to the firm's report, the increase in securities on loan indicated that the borrowing was a "precautionary measure to guard against overly stringent interpretations of the rule, a possible lack of exemption for market makers, and a potential dearth of shares within a market governed by a new paradigm." See *Analysis of the Effect of the SEC's Special Order*.

[83]See SEC Press Release 2009-76.

Regulators Have Categorized Noncompliance with Regulation SHO as Nonsystemic, but the Regulation Presents Some Compliance Challenges

After SEC implemented Regulation SHO, SEC and the SROs took steps to enforce its requirements—first by conducting a joint sweep examination, and later by conducting routine and other compliance examinations and regular surveillances of FTD data. While these examinations have found a significant number of firms with Regulation SHO compliance deficiencies, OCIE and SRO staffs told us these deficiencies generally were not indicative of systemic problems or attempts to manipulate a security. However, broker-dealers are facing challenges in complying with Regulation SHO's requirement to determine whether the locates they obtain prior to effecting a short sale are reasonable sources for securities needed at settlement.

Although SEC and the SROs Found Noncompliance with Regulation SHO, They Characterized It as Technical and Brought Few Enforcement Actions

SEC and SRO examinations have found that most Regulation SHO deficiencies by broker-dealers and options market makers appear to be nonsystemic deficiencies. As of April 1, 2009, two SROs have brought several compliance actions. Within months of Regulation SHO's compliance date and in coordination with Trading and Markets, OCIE, NYSE, and the former NASD conducted a coordinated sweep examination of 19 clearing broker-dealers that execute and clear short-sale transactions.[84] The 19 firms were selected from NASD- and NYSE-generated lists of firms that had aged FTD in threshold securities. The purpose of the sweep examination was to determine whether firms were in compliance with Regulation SHO's locate, close-out, or order-marking requirements, along with other Regulation SHO requirements.[85] Examiners also reviewed the adequacy of the firms' written supervisory procedures for ensuring compliance with these requirements. These joint sweep examinations found deficiencies with Regulation SHO requirements at all 19 broker-dealers.

OCIE and SRO examiners told us that they generally did not find evidence that these deficiencies were part of a deliberate problem or part of

[84]In July 2007, NASD (which regulated the OTC market for exchange-listed and non-exchange-listed securities and provided regulatory services to markets, such as Amex and NASDAQ) merged with the member regulation, enforcement, and arbitration functions of NYSE to form FINRA.

[85]The order-marking requirement states that broker-dealers are to mark the sale of each security correctly as either long or short. Examiners test compliance with this requirement to ensure that broker-dealers are not mismarking trades to evade compliance with other provisions of Regulation SHO, such as the locate requirement, or other SEC rules.

attempts to manipulate a security. For example, deficiencies related to the close-out requirement generally involved limited instances with a majority of the firms having failed to deliver in only one or two securities. As a result of the sweep examination, NYSE brought formal enforcement actions against four of its members. According to examiners who had participated in the examinations of these firms, NYSE brought these enforcement actions because it believed that the firms had been given adequate time before Regulation SHO went into effect to develop processes and procedures for compliance with the requirements. OCIE also found that the most serious finding was that most of the firms did not have adequate written supervisory procedures to ensure compliance with Regulation SHO.

Although OCIE does not conduct routine examinations of SRO member firms for Regulation SHO compliance, OCIE officials stated that between January 2005 and October 2008, OCIE conducted approximately 90 cause or broker-dealer oversight examinations that included a review of the firm's compliance with Regulation SHO.[86] Of these examinations, 41 had Regulation SHO-related findings. We reviewed 12 of the 41 examinations with Regulation SHO findings and found that the findings reported were similar to those of the 2005 sweep examination.[87] For example, examiners generally found deficiencies in marking trades or performing an appropriate locate prior to effecting a short sale in some firms. To assist OCIE in their examinations, we found that OEA conducted multiple analyses using NSCC-provided FTD and threshold list data to analyze data on particular firms. Most recently, as part of a sweep examination, OCIE stated that it has initiated 4 examinations to assess compliance with the October 2008 rule changes. To date, SEC has not charged violations of Regulation SHO in any enforcement actions.[88] However, according to SEC

[86]According to OCIE officials, approximately half of these 90 examinations were broker-dealer oversight examinations and half were cause. Of the cause examinations, none were originated to review Regulation SHO, but in many instances examiners included a review after preliminary examination work revealed concerns.

[87]We chose examinations for review on the basis of the general business model of the broker-dealer, the perceived size of the broker-dealer, and the year in which the examination took place.

[88]However, SEC has charged other violations in settled matters where the conduct was similar to that prohibited by Regulation SHO. In the Matter of Sandell Asset Management Corp., et al., Securities Act Release No. 8857, October 10, 2007, and in the Matter of Goldman Sachs Execution & Clearing, L.P., Securities Exchange Act Release No. 55464, March 14, 2007. Neither of these administrative proceedings were the result of examination findings.

Enforcement staff, Regulation SHO is largely enforced by the SROs because of the regulation's focus on broker-dealer operations.

After the initial 2005 sweep examinations were completed, the SROs continued to monitor the industry for compliance with Regulation SHO through routine examinations and electronic surveillance. FINRA continued to monitor firms for Regulation SHO compliance by incorporating an assessment of Regulation SHO compliance into three of its routine examination programs: the Risk Oversight and Operational Regulation Program, which focuses on clearing firms; the Sales Practice Examination Program, which focuses on introducing firms; and the Trading and Market Surveillance Program, which complements existing automated surveillance.[89]

We reviewed the examination modules for each of the three FINRA programs. To assess compliance with the locate and order-marking requirements, the modules direct examiners to use various methods to select samples of trades for review. For the selected sample, examiners are directed to review a firm's supporting documentation—such as locate logs, trade blotters, position records, and FTD ledgers.[90] Similarly, to assess whether a clearing broker-dealer appropriately closed out FTD in threshold securities, examiners are directed to select and analyze a sample of FTD from the firm's FTD ledgers. We found that FINRA had taken steps to update the examination modules to reflect the stricter close-out requirements of the temporary rule.

[89]FINRA conducts the Risk Oversight and Operational Regulation Program, the Sales Practice Examination Program, and the Trading and Market Surveillance Program examinations of member firms every 1, 2, or 4 years, depending on FINRA's risk assessment of the member firm. Larger firms that cover a significant share of the marketplace and firms that have other high-risk attributes, such as a prior enforcement action or serious deficiencies, are considered high risk and examined every year. FINRA's Market Regulation Short Sale Section conducts automated surveillance to assess member compliance with FINRA's monthly short position reporting and to detect potentially abusive practices associated with short sales. The effectiveness of this surveillance depends on whether members are accurately marking their sale orders.

[90]FINRA's uses various methods for selecting a sample of trades for review. For example, the Trading and Market Surveillance Program had developed a sampling process that selects trades that may be indicative of Regulation SHO violations.

According to FINRA data, between January 1, 2005, and December 31, 2008, FINRA conducted 1,124 routine examinations of its members through the 3 programs. Of these examinations, 302 contained Regulation SHO deficiencies. FINRA staff stated that they have not detected any particular trends or patterns in the types of violations that would indicate systemic abuse, and do not consider the deficiencies found in these examinations to be egregious. For example, staff found in 1 examination that locates were not performed for 4 trades out of a sample of 60 trades. In another example, examiners sampled 10 short sale transactions and found 1 instance where the amount sold short exceeded the amount located by 1,000 shares.

In addition to its examination programs, FINRA also uses automated surveillance to identify firms with close-out obligations for all threshold securities within a specified period. Specifically, we found that FINRA runs quarterly reports using FTD data obtained from NSCC to identify all threshold securities for that quarter and those clearing firms with potential close-out obligations in those securities—that is, aged FTD in threshold securities. FINRA staff then contact these firms to determine why the potential close-out obligation has not been met, and to determine whether there are any violations of Regulation SHO or whether the aged FTD were due to legal exceptions. Since the adoption of the temporary rule, FINRA staff stated that FINRA has updated its surveillances to monitor for FTD in all securities, and that it runs the surveillance on a bimonthly basis. FINRA then selects firms identified by this surveillance to contact to determine why the potential close-out obligation has not been met and to determine whether there are any violations of Regulation SHO.

CBOE also monitors its membership for compliance with Regulation SHO through its member firm examinations and surveillances. Between January 1, 2005, and December 31, 2008, CBOE conducted 326 examinations that included a review of Regulation SHO requirements. Of these examinations, 152 contained some level of apparent Regulation SHO violations (i.e., 140 marking violations, 65 locate violations, and 26 close-out violations).[91] Due to their nature, the majority of these violations were resolved through nonformal disciplinary action. CBOE also participated in a 2006 sweep

[91]CBOE officials stated that member firm examinations are conducted every year for the largest clearing firms and for those firms that conduct business with public customers. The remaining members are examined up to every other year. The total number of violations exceeds the number of examinations with Regulation SHO findings because some examinations contained more than one type of violation.

examination that focused on the options market maker exception to the close-out requirement for aged FTD in threshold securities that were open for 13 consecutive days. CBOE staff also have developed surveillance to help detect noncompliance with the close-out requirements of Regulation SHO.

Moreover, beginning in early 2005, SRO staff identified multiple traders that appeared to be using an illegal trading strategy to inappropriately avoid the close-out requirement of Regulation SHO. These traders were identified through SRO surveillance and complaints that the SRO received. As a result of FINRA's surveillances and investigations, which were conducted on behalf of the American Stock Exchange (Amex), the exchange brought two formal disciplinary actions for violations of Regulation SHO against two options traders.[92] Amex alleged that the options traders improperly used the market maker exception to engage in naked short selling without first obtaining a locate, and circumvented the delivery obligation through various trading schemes. CBOE has also initiated 26 investigations against member firms for similar apparent activity. As of February 19, 2009, 7 cases have been presented to the CBOE's Business Conduct Committee. CBOE and FINRA staffs stated that since the above Amex actions regarding two traders became public, this type of activity appears to have ceased.

In Part Because SEC Has Not Finalized Guidance, the Industry Has Experienced Some Challenges in Complying with the Locate Requirement

Regulation SHO requires broker-dealers to demonstrate that the sources on which they rely for locates are reasonable—that is, the broker-dealer does not have reason to believe that the source will be unable to deliver shares in time for settlement. Firms are also required to have procedures or systems in place to determine whether it is reasonable to rely on customer assurances or an easy-to-borrow list. However, in both the initial sweep examinations and subsequent oversight and sweep examinations, OCIE has found that some firms do not have procedures or systems in

[92]Disciplinary Panel, American Stock Exchange LLC, Case No. 07-174 (Brian A. Arenstein and ALA Trading LLC) and Case No. 07-71 (Scott H. Arenstein and SBA Trading LLC). According to the findings of Amex, each options trader utilized the market maker exemption to impermissibly engage in naked short selling by failing to locate securities to borrow and then engaged in a series of close-out transactions designed to circumvent Regulation SHO delivery obligations in such securities by creating the appearance of a bona fide repurchase of the securities the trader initially had sold short. In both proceedings, it was found that as a result of this trading activity, each trader was able to maintain impermissible naked short positions in a number of Regulation SHO threshold securities for a virtually unlimited period of time.

place to monitor whether the locate source was reasonable. According to OCIE examinations, some broker-dealers are not monitoring to determine whether locates are resulting in FTD because firms do not expect that the source from which the firm obtained the locate will be the source from which the firm will obtain shares for settlement. As a result, it may be difficult for broker-dealers and regulators to determine whether a locate source is reasonable because the source that provided the locate for past trades may or may not have been the source from which the clearing broker-dealer attempted to obtain shares for settlement.

According to SEC and SRO staffs and industry officials the source used to borrow shares and make delivery can differ from the locate source for several reasons. The clearing broker-dealer may simply decide to use a source other than the source used to obtain the locate. For example, a broker-dealer may decide to use shares from its own inventory instead of going to the source of its locate, or the locate source provided by the customer. In addition, the netting process of the clearance and settlement system may result in a broker-dealer not being required to deliver any shares or only a portion of the total sold short, thus eliminating the need to borrow securities or reducing the amount required and potentially eliminating the need to borrow from the source used to obtain a locate for a specific trade. The source used to borrow shares also may be different than the locate source because securities that are available on trade date may not be available on the settlement date from that locate source, when borrowing is effected to settle the short sale. Conversely, a source that may not be able to provide a locate on trade date may have the securities available to be loaned on the settlement date.

We also found that executing broker-dealers may not always have the information necessary to make a determination that the locate source provided by the customer is reasonable. According to FINRA staff and industry officials, this is most common in prime brokerage transactions where the customer delivers the securities to the prime broker rather than to the executing broker for settlement of sell orders. As we have previously discussed, Regulation SHO requires the executing broker-dealer to locate shares available for borrowing prior to effecting a short sale. An executing broker may fulfill this requirement by relying on a customer's representation that it has obtained the locate from another source. However, because Regulation SHO does not obligate the clearing firm—in this case, the prime broker—to provide trade settlement information to the executing broker, the executing broker may not know if, at settlement, the prime broker was unable to borrow shares to delivery,

and thus may not have the information necessary to determine whether it can rely on that customer's locates for future short sale transactions.

Industry, Trading and Markets, and FINRA staffs said that this information gap in Regulation SHO could be addressed by clarifying the responsibilities of the prime broker and executing broker to ensure compliance with Regulation SHO. In March 2007, Trading and Markets and industry representatives helped provide this clarification by drafting revisions to the Prime Broker Letter issued by SEC staff in 1994. According to the industry officials working with Trading and Markets, these revisions are intended to enhance communications between the prime broker and executing broker and to help ensure that the customer is providing accurate information to the executing broker. Furthermore, these revisions would provide the executing broker with the information necessary to make a determination of whether a customer's assurance is reasonable.

As of April 2, 2009, Trading and Markets has not yet finalized the revised Prime Broker Letter to make it effective. Trading and Markets staff said that because SEC still is evaluating comments on the temporary rule and it remains subject to modification, they cannot sign the letter. According to these staff, the draft letter reflects Regulation SHO as adopted, and officials need to review the letter to determine whether any adjustments are necessary to reflect the provisions of the temporary rule, if it is adopted as final. The letter was revised in March 2007, prior to the issuance of the temporary rule in September 2008, and the information gap has existed since Regulation SHO became effective in January 2005.

Without access to the information from prime brokers that would allow them to establish whether customer-provided locates are resulting in FTD, executing broker-dealers may not be able to achieve compliance with Regulation SHO. In addition, this information gap may create the perception that prime brokerage customers—typically, hedge funds or large investors—are allowed to circumvent Regulation SHO and naked short sell. SEC has said on several occasions that the perception that FTD may be indicative of manipulative naked short selling can damage investor confidence and the stability of the market. By completing its review and finalizing the revised 1994 Prime Broker Letter, SEC can ensure that this information gap is closed, and that the parties responsible for executing and clearing and settling trades (1) establish the communication processes necessary to comply with Regulation SHO and (2) make the appropriate determinations about customer-provided locates.

Regulators Use Complaint Information, Surveillance, and Examinations to Identify Potential Manipulative Short Selling, but It Is Difficult to Prove Manipulation

Regulation SHO compliance violations do not necessarily indicate that manipulative naked short selling has occurred. If examiners identify indications of potential manipulative trading, OCIE or FINRA can pursue further investigation or refer the case to their respective Enforcement divisions for further investigation. For example, we reviewed one OCIE examination where possible Regulation SHO violations led to such a referral. As we have previously discussed, regulators have found Regulation SHO deficiencies to be nonsystemic and not indicative of abuse or attempts to manipulate individual securities. SRO staff stated that Regulation SHO is effective from an examination and enforcement perspective because it specifically identifies the parties responsible for obtaining a locate or closing out FTD and identifies when each of these responsibilities is to be completed. Furthermore, because Regulation SHO was designed to curb manipulation facilitated by naked short selling and address large and persistent FTD by imposing operational requirements on regulated entities, the SROs are able to bring regulatory actions against their members for Regulation SHO violations.

SEC and the SROs rely on complaints, tips, and electronic market surveillance, among other things, to identify suspicious trading activity, including potential instances of manipulative naked short selling.[93] Enforcement staff stated that while it is not difficult to determine whether there are FTD in a security, they have found through their experiences and discussions with the SROs that FTD are not a proxy for manipulative conduct and do not provide regulators with much information regarding possible manipulation. For example, a FTD could occur, but that information alone does not tell a regulator whether there was intent to fail to deliver or whether an appropriate locate was conducted. Also, as we have previously discussed, FTD may result from long or short sales. To determine if a trader was successful in manipulating the market through naked short selling, regulators must unwind FTD and trading activity, which requires considerable analysis of trading data and other supporting documentation, such as e-mails, and reliance on large amounts of circumstantial evidence. Furthermore, according to Enforcement and

[93]For a detailed description of how the SROs and SEC investigate potential market manipulation cases and of the process that SEC uses to respond to complaints, see GAO, *Securities and Exchange Commission: Opportunities Exist to Improve Oversight of Self-Regulatory Organizations*, GAO-08-33 (Washington, D.C.: Nov. 15, 2007). The SEC Inspector General also recently issued a report on SEC's process for responding to manipulative naked short selling complaints and referrals. See SEC, *Office of Audits, Practices Related to Naked Short Selling Complaints and Referrals. Report No. 450* (Mar. 18, 2009).

FINRA staffs, manipulation investigations, including manipulative naked short selling, are complex matters and the standard of proof, especially proving intent, to prevail in an enforcement action is high. Enforcement stated that quantifying the amount of manipulative activity, including manipulative naked short selling, that occurs in the market is difficult.

According to FINRA, most market manipulation is identified through activities of the market surveillance divisions at the SROs that review market activity for aberrant price and volume movement in the security that can suggest manipulation. The SROs have established electronic surveillance systems that generate an alert if a security's price or volume of shares traded, among other things, moves outside of set parameters. These price and volume movements can indicate a number of illegal trading practices, including manipulative naked short selling. A significant factor in determining whether an aberrant movement was a case of potential manipulative naked short selling is if a FTD appears at NSCC 3 days after the aberrant movements. SRO staff review thousands of alerts annually to identify those that are most likely to involve fraud or warrant further investigation on the basis of a variety of factors, such as profit potential and news related to the security. In the course of a full investigation, the SROs gather information from their member broker-dealers, including the names of individuals and organizations that were active in trading during the time in question.[94] When an SRO finds evidence of illegal trading involving its members, it can conduct disciplinary hearings and impose penalties ranging from disciplinary letters to fines to expulsion from trading and SRO membership. Because the SROs do not have jurisdiction over entities and individuals that are not part of their membership, they refer suspicious trading on the part of nonmembers, including customers, directly to SEC Enforcement.

[94]The SROs gather this information through a variety of processes, including "bluesheeting." When bluesheeting a broker-dealer, the SROs request detailed information about trades performed by the firm and its client, including the security's name, the date traded, price, and transaction size. The questionnaires that the SROs use originally were printed on blue paper, hence, the name blue sheets. Today, due to the high volume of trades, this information is provided electronically.

SEC Is Considering Finalizing the Temporary Rule by July 2009, but Implementation Issues and Inconsistent and Untimely Provision of Guidance Concern the Industry

Industry officials said that the stricter close-out requirements imposed through the September emergency order and the temporary rule have resulted in several unintended negative consequences on security prices and securities lending.[95] Trading and Markets staff said they are reviewing these concerns to determine whether any changes to the requirements are warranted before the Commission considers finalizing the rule by July 2009. The industry also has experienced operational issues in implementing Regulation SHO and the temporary rule, but Trading and Markets responsiveness to industry requests for guidance on these issues has been mixed.

Although Generally Supportive of SEC's Efforts to Prevent Abusive Naked Short Selling, Industry Officials Said That New Close-out Requirements Have Raised Operational Issues

According to several comment letters submitted to SEC on the temporary rule, the industry generally supported the fundamental tenets of the temporary rule, including a compressed mandatory close-out obligation for all equity securities. However, industry commenters cited several negative consequences that resulted from the temporary rule, noting that it potentially contributed to market volatility and price spikes at market open and to instability in the securities lending market. Industry commenters said that the requirement that broker-dealers close out FTD by the opening of trading on T+4 (for short sales) or T+6 (for long sales or bona fide market maker sales) inadvertently contributes to increased market volatility and price spikes at market open. For example, a large industry group's comment letter referenced 40 instances in which these close-out requirements potentially created significant but temporary upward pressure on the price of certain hard-to-borrow optionable securities at the opening of trading. According to this letter, the price of these securities opened trading at least 15 percent above the previous night's closing price, but prices receded back to approximately the previous night's closing price within 30 minutes.

Industry officials also said that the new close-out requirements are having a negative impact on the efficient operation of the securities lending

[95]These industry officials represented the views of several broker-dealers and a large industry trade association with whom we spoke.

market, leading potentially to reduced inventory of shares available for borrowing, increased borrowing costs, and reduced liquidity. According to an industry group comment letter, when a security that is out on loan is sold, the lending agent will first attempt to reallocate the loan by identifying other customers with shares available for lending. If that effort is not successful, the lending agent must recall the loaned shares from the borrower. The comment letter continues by explaining that the recall is typically done through a written notice and takes place 1 or 2 days after the trade, with the majority of the notices issued 2 days after the trade. The borrower then has 3 full days to return the securities—in effect, until the end of T+5. According to the comment letter, when the lending agent receives the shares late on T+5, it returns the shares to the lender or its agent, which must then deliver the shares for settlement. In many cases, the ultimate delivery of shares will not be processed until the morning of T+6. Under the temporary rule, FTD resulting from long sales—which include the sale of securities out on loan—are required to close out by the opening of trading on T+6. According to some comment letters and industry officials, this requirement leaves little or no time for securities lenders to deliver recalled shares in time to avoid being bought in at the opening of trading on T+6. Furthermore, two large industry trade groups commented that most current broker-dealer and clearing firm systems are unable to differentiate between FTD that resulted from long sales versus FTD that resulted from short sales, with one stating that any differentiation requires extensive manual processing that typically cannot be completed by the opening of trading on T+4. As a result, some industry comment letters and officials stated that some broker-dealers are closing out all FTD on T+4, regardless of whether they are the result of a long or short sale, which further increases securities lenders' risk of being bought-in and causes some lenders to exit or reduce their participation in the market.

To resolve these concerns, several industry officials recommended that SEC require broker-dealers to close out all FTD, regardless of whether they result from long or short sales, by the close of trading on T+6. These commenters said that doing so would allow for those FTD that occur for processing reasons to be cleared up without the need to borrow and deliver or buy-in FTD. Furthermore, they said closing out all FTD by the close of trading on T+6 also would eliminate the need for broker-dealers to engage in complex; time-consuming; and, at times, imperfect processes in an effort to determine whether a FTD was due to a long or short sale, because all FTD would be treated the same. Several industry officials with whom we spoke also stated that it may not be possible to build systems capable of differentiating between FTD that resulted from long sales

versus FTD that resulted from short sales prior to the opening of trading on T+4. However, because they are unsure about what the requirements will be after the rule is finalized, industry officials told us they are not yet attempting to build these systems.

Some industry commenters also recommended that SEC change the close-out requirement to allow clearing broker-dealers to close out their FTD throughout trading on the required close-out day, instead of only in the morning at market open. According to one industry comment letter from a large industry trade group, as a practical matter, transactions effected at market open to close out FTD are no different than those effected later in the trading session because both types are part of the same clearance and settlement cycle. As such, the group said that this change would allow clearing broker-dealers to close out FTD as currently intended by the temporary rule, but eliminate the volatility and price spikes associated with all FTD being required to close out prior to or at the opening of trading.

Although SEC and FINRA acknowledge that the industry may be required to make system changes to comply with the requirements of the temporary rule, they believe the industry is capable of accomplishing these system changes necessary for compliance. According to OCIE staff, during a recent sweep examination of prime brokers they found that one broker had already developed the capability of tracking its FTD back to the trade that caused the FTD and then identifying whether that trade was marked long or short. Examiners conducting these sweep examinations also stated that the prime brokers they reviewed are able to identify the customers that are failing to deliver to the prime brokers, and that determining whether a trade was marked as long or short would most likely not require much additional effort. However, they did note that each firm probably will have a different infrastructure with which to work so each firm's implementation of the requirements may be unique. Trading and Markets staff also said that while they are considering all of the comment letters and proposed amendments to the rule, any change to extend the current T+4 buy-in date for FTD resulting from short sales expands the time frame in which manipulative naked short selling could occur, potentially undermining the Commission's policy objective of curbing this type of abuse.

Trading and Markets Responses to Industry Requests for Guidance Were Sometimes Inconsistent during Regulation SHO and the Emergency Orders or Were Not Timely

SROs and industry officials noted that SEC staff were responsive to some requests for implementation guidance regarding Regulation SHO and the recent emergency orders; however, in some instances where complex issues have arisen or the application of the rules to a particular scenario was unclear, industry officials and staff from one SRO with whom we spoke said that other requests went unanswered or experienced lengthy delays. Staff from one SRO said that Trading and Markets has issued numerous guidance and interpretive products and continuously updated these products. Trading and Markets can provide interpretive guidance to the SROs and industry through a number of publications, such as exemptive orders, no-action letters, compliance guides, staff legal bulletins, and answers to frequently asked questions. However, Trading and Markets staff do not have a formal (i.e., written) process to determine when requests from industry and SROs merit a formal response. Instead, staff have discretion to determine when SRO and industry request merit such a response. Staff from another SRO noted that SEC worked with them to approve an appropriate methodology to use to assess Regulation SHO exemption determinations. SRO staff told us that because the SROs do not have the authority to independently issue interpretative guidance on SEC rules, they must obtain this guidance from SEC for their own and members' consideration when necessary. The SRO staff cited an occasion when they attempted to put guidance in a compliance circular that used SRO interpretations to answer specific questions it or its membership had regarding Regulation SHO. This SRO was delayed in providing the guidance to its members because of the time that passed before SEC provided feedback on whether the SRO's interpretations were correct. In this example, the SRO submitted a list of technical operational questions, ranging from basic questions about the close-out requirement to hypothetical situations that were described to elicit the meaning of certain phrases to Trading and Markets. Although communication took place between the SRO and SEC, an extended period of time passed between the initial document being submitted to Trading and Markets and the SRO providing answers to its members. The SRO also stated that in some instances in which it had asked for guidance, Trading and Markets told the SRO that the regulation was clear and no additional guidance was necessary.

Industry officials with whom we spoke also stated that the SEC staff's responses to their requests for implementation guidance, particularly for recent emergency orders, have been inconsistent. Several market participants said that because Regulation SHO was enacted after a lengthy comment period and firms were given many months to put systems and policies and procedures in place, many of the potential implementation

issues were discovered and resolved prior to the regulation being enforced. However, the July and September emergency orders and the temporary rule were made effective the day they were issued, or soon thereafter, with little or no advanced warning. According to some industry officials, these orders required system changes, some on a global basis, and numerous implementation issues arose. Industry officials said that, in some cases, they were able to work quickly with Trading and Markets to resolve these issues. For example, 3 days after the July emergency order restricting short selling securities of certain financial firms, SEC amended the order to exempt bona fide market making from the requirement. Nevertheless, industry officials stated that, in other situations, SEC was not responsive to their requests for guidance. For example, industry officials stated that due to the rushed nature of the September emergency order and the temporary rule, there was a lot of uncertainty and confusion related to the scope and application of the new requirements. Although some issues were addressed promptly, other industry requests for clarification or additional guidance remained unresolved.

Trading and Markets staff stated that they did not believe issuing formal guidance was appropriate for some of the requests for interpretive guidance on Regulation SHO, because they felt the regulation was clear or that the request was more for a change of rule that would require going back to the Commission than an interpretation. Trading and Markets staff also told us that they did not want to provide answers to some of the requests that asked for guidance in specific circumstances, because they felt such requests were attempts to find loopholes in Regulation SHO, rather than attempts at compliance. These staff stated that because the temporary rule is set to expire on July 31, 2009, they are focused on reviewing and analyzing the written comments received to provide a recommendation to the Commission about the final form of the rule. They also said that providing the industry with guidance on a rule the Commission is still attempting to finalize would be difficult, and that the staff do not have a process by which implementation issues that arise from temporary rules can be readily addressed. Furthermore, responding to some of the implementation issues could have potentially required changes to the temporary rule, something that Trading and Markets is not authorized to do.

By the time that the Commission takes final action on the temporary rule, it will have been in effect for 10 months, during which time the industry may have been inconsistently implementing its requirements. Trading and Markets' varied and, at times, untimely responsiveness to industry and SRO requests for interpretive guidance on Regulation SHO and the

emergency orders conflict with the goals articulated in SEC's current *Strategic Plan*.[96] The plan states that SEC should write regulations that are clearly written, flexible, and relevant and do not impose unnecessary financial or reporting burdens. One potential measure for monitoring progress the plan outlines is the length of time to respond to no-action letters, exemptive applications, and interpretive requests. The *Strategic Plan* also states that as part of its efforts to ensure compliance with federal securities laws, SEC should work to enhance its interpretive guidance process to meet the needs of the staff, the public, and other external stakeholders. Without timely and clear interpretive guidance from SEC, SROs may be unable to effectively enforce SEC rules and regulations, and SEC cannot ensure the consistent implementation of the rules and regulations.

Conclusions

FTD may undermine the confidence of investors, making them reluctant to commit capital to an issuer that they believe to be subject to such manipulative conduct. While our review of FTD data showed that the majority of securities graduated from the threshold list in a timely manner, we also found that about 80 percent of threshold securities returned to the list, and some securities persisted for considerable periods of time. We recognize that there are legitimate reasons why a security could persist on the threshold list, but the cause for extended FTD in any individual security only can be assessed through regulatory scrutiny and generally is not apparent to the investing public, which may have concerns that securities on the threshold list are the target of manipulative naked short selling.

With the requirements of the temporary rule, SEC has made progress in facilitating the goal that all sellers of securities should promptly deliver, or arrange for delivery of, securities to the respective buyer, and that all buyers of securities have a right to expect prompt delivery of securities purchased. Of the threshold securities remaining in December 2008, about 50 percent were ETFs. SEC and SRO staffs have begun assessing the reasons for FTD in these securities, and they believe structural characteristics in the creation and redemption of these securities are a critical factor. While these staff said their assessments do not currently lead them to believe that these securities are vulnerable to manipulative naked short selling, continued scrutiny of these products should help SEC

[96]SEC, *2004-2009 Strategic Plan.*

confirm this assessment and determine whether Commission action is needed to address the causes for FTD in these products.

Although Trading and Markets staff are continuing to study the effects of the temporary rule, they and FINRA staff believe that the locate and close-out requirements of Regulation SHO, and particularly the enhanced close-out requirements of the temporary rule, have made it less likely for traders to effect short sales that result in persistent FTD. While we agree that the close-out requirements of the temporary rule likely have reduced the opportunity to create persistent FTD and, thus, the incentive to engage in manipulative naked short selling, some potential for this illegal conduct still may exist. In response to an alternate suggestion to implement a marketwide preborrow requirement, Trading and Markets and FINRA staffs said such a requirement might be costly to the industry because FTD represent a very small percentage of the dollar value of trades and only a small group of securities would likely be the target of any manipulative scheme. However, Enforcement and FINRA staffs said that market manipulation is difficult to detect and successfully prosecute, and the potential damage to an individual company could be severe. For these reasons, an important element of continued evaluation of the effects of the temporary rule will be a careful evaluation of whether the T+4 close-out requirement is sufficient to protect the most vulnerable firms from market manipulation.

Another potentially important aspect of any SEC determination regarding whether to continue to rely on the current locate and close-out requirements for mitigating manipulative short selling will be an evaluation of the effectiveness of the current locate requirement in reducing FTD and the potential for market manipulation, with a particular focus on the reliability of easy-to-borrow lists—that is, these lists must represent securities that are available for borrowing. Regulation SHO lacks specific criteria regarding what constitutes an easy-to-borrow security, but SEC found that a few firms have not followed industry best practices, which call for decrementing their inventory as locates are provided. We note that unless firms follow such best practices, it is not clear how they can ensure that they are providing locates only on their available supply of securities and limiting the potential for FTD. However, because following industry practice is voluntary, the magnitude of firms overlocating or including securities that are not easy to borrow on the list is currently unclear.

Our review also found that the industry currently faces challenges in complying with Regulation SHO's requirement to assess whether locates

provided by customers are reasonable and not resulting in FTD, particularly in the context of prime brokerage. Regulation SHO currently does not provide executing brokers with access to information from prime brokers that would allow them to establish whether customer-provided locates are resulting in FTD. Although SEC worked with the industry to revise the 1994 Prime Broker Letter in 2007, it has not completed its review of the letter, citing its need to wait until the Commission determines whether to finalize the temporary rule. By finalizing the revised Prime Broker Letter, SEC would provide the means by which executing brokers could evaluate customer-provided locates to determine whether they are reasonable and thus comply with the locate requirement. Moreover, finalized guidance would help alleviate investor concerns that such conduct could occur.

In implementing the new close-out requirements though emergency order and extending them through a temporary rule, SEC imposed requirements on the industry without first providing for the usual comment period. In their comment letters, market participants generally supported the fundamental tenets of the temporary rule, including a compressed maximum close-out obligation for all equity securities; however, they also have identified several operational issues and negative consequences caused by the implementation of the temporary rule. According to Trading and Markets staff, they had been unable to respond to some of these issues raised by the industry because the requirements were issued as a temporary rule and certain changes would require a rule change approved by the Commission. Furthermore, Trading and Markets staff said that it would be difficult to provide guidance to the industry about other issues until the Commission determines whether to finalize the temporary rule, which potentially will not occur until July 2009. We recognize that Trading and Markets staff currently may have limited ability to resolve issues arising from the implementation of a temporary rule without obtaining input or authorization from the Commission. Without a formal process in place that would give Trading and Markets staff a basis upon which to address implementation issues that arise in connection with interim final temporary rules in a timely manner, staff are unable to respond adequately to concerns of industry participants affected by the rule. Moreover, while providing formal responses to all requests for interpretive guidance may not be appropriate, establishing a formal process would provide a basis for consistently addressing matters relating to compliance with SEC regulations. Doing so also would help prevent negative impacts from temporary rules in the periods before expiry or finalizations. Furthermore, providing timely answers to SRO and industry requests is important for

SROs and industry to help ensure consistent implementation of SEC rules and regulations.

Recommendations for Executive Action

To address the current information gap in Regulation SHO for prime brokerage arrangements and mitigate the impact of any unintended consequences caused by SEC rules, as well as ensure consistent implementation of SEC rules by the industry, we recommend that the Chairman of the Securities and Exchange Commission take the following two steps:

- finalize, in an expedited manner upon finalization of the temporary rule, the revised 1994 Prime Broker Letter and
- develop a process that allows Commission staff to raise and resolve implementation issues that arise from SEC regulations, including interim final temporary rules, in a timely manner.

Agency Comments and Our Evaluation

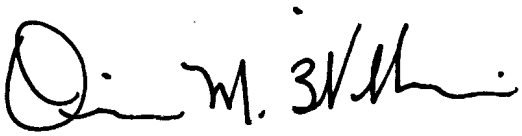
We provided a draft of the report to the Chairman of the Securities and Exchange Commission for her review and comment. We also provided relevant portions of the report to FINRA and CBOE for their review and comment. We received technical comments from SEC, FINRA, and CBOE, that were incorporated, where appropriate. SEC provided written comments that we reprinted in appendix IV.

In its written comments, SEC stated that regarding our first recommendation, it will consider the need to clarify the communications between prime broker-dealers and executing broker-dealers that would facilitate Regulation SHO compliance in connection with its consideration of further action on the temporary rule. We encourage SEC to take the steps necessary to clarify this communication. In doing so, SEC would provide the means by which executing brokers could evaluate customer-provided locates to determine whether they are reasonable and facilitate compliance with the locate requirement. Moreover, finalized guidance would help alleviate investor concerns that such relationships could be exploited to engage in manipulative naked short selling. Regarding our second recommendation, SEC noted that it regularly provides guidance to the industry and outlines that routine rulemaking provides a time for comments prior to the adoption of the final rule. It also noted that, unlike routine rulemaking, when SEC promulgates a rule or regulation as an interim final temporary rule, the rule is adopted and in effect during the

comment period. SEC stated that it is committed to engaging in a deliberative process to develop meaningful regulation of short selling and providing interpretive guidance to the industry to facilitate implementation, as appropriate. SEC also stated that it will evaluate whether there are additional steps that it can take, consistent with the Administrative Procedure Act, to address implementation issues raised by industry. Again, we encourage SEC to take the steps necessary to determine what additional steps can be taken to address implementation issues raised by the industry and SROs, especially regarding interim temporary final rules, which can be in effect for significant periods of time. While providing formal responses to all requests for interpretive guidance may not be appropriate, establishing a formal internal process consistent with the Administrative Procedure Act to facilitate providing timely answers to SRO and industry requests would help ensure effective administration of SEC rules and regulations. Furthermore, a formal process would help reduce the chances of negative consequences of temporary rules occurring during the periods before expiry or finalizations.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to interested congressional committees, the Chairman of the Securities and Exchange Commission, and other interested parties. The report also will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staffs have any questions about this report, please contact me at (202) 512-8678 or williamso@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs can be found on the last page of this report. Key contributors to this report are listed in appendix V.



Orice M. Williams
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Appendix I: Scope and Methodology

To provide an overview of the actions that the Securities and Exchange Commission (SEC) has taken to address manipulative naked short selling and failures to deliver (FTD), including Regulation SHO and the recent emergency orders—and the factors SEC considered in taking these actions, we reviewed Regulation SHO; the recent July and September 2008 emergency orders, including associated amendments; and the interim final temporary rule (temporary rule) and interviewed staff from SEC's Division of Trading and Markets (Trading and Markets). We also obtained copies of related rules issued by the former NASD.

To discuss the potential impact of Regulation SHO on FTD in threshold and nonthreshold securities using trend analysis, we obtained (through SEC) FTD data that the National Securities Clearing Corporation (NSCC) generated from April 1, 2004, to December 31, 2008.[1] We chose to obtain data going back to April 1, 2004, because we wanted to identify any trends in FTD prior to the effective date of Regulation SHO in January 2005, and because April 1, 2004, was the earliest date SEC began receiving FTD data from NSCC. We also obtained the daily lists of threshold securities published by the equities self-regulatory organizations (SRO) from January 10, 2005 (the date the first threshold list was published), through December 31, 2008.

From these data, we generated a number of graphics to illustrate trends in threshold securities, including the number of threshold securities and the level of outstanding and new FTD in these securities, both across the market and by individual markets. We generated other descriptive statistics from the data on threshold securities, such as the number of securities that had persisted for more than 90 days on the threshold list over this period. In addition, we generated graphics illustrating trends in FTD in all equity securities across the market and, by individual market, from April 1, 2004, through December 31, 2008. In performing our analyses, we conducted a data reliability assessment of the NSCC data. To do so, we reviewed a 2005 SEC Office of Compliance Inspections and Examinations (OCIE) examination that, in part, assessed NSCC's processes for generating reports that are used to provide daily FTD data to SEC and the

[1]A threshold security is an equity security where, for 5 consecutive settlement days, (1) aggregate FTD at a registered clearing agency constitute 10,000 shares or more; (2) the level of FTD is equal to at least one-half of 1 percent of the issuer's total shares or more; and (3) the security is included on a list published by the SROs. To be removed from the threshold list, the level of FTD in a security must not exceed the threshold for 5 consecutive settlement days.

equities SROs. We also employed our own data reliability tests by taking a random sampling of trading dates and verifying that the listing of threshold securities provided to us by SEC matched those published by the New York Stock Exchange (NYSE), NASDAQ, and the American Stock Exchange (Amex). In addition, we reviewed these data for missing values and outliers as well as for the accuracy of pricing information. We determined that these data were reliable for our purposes. As part of our work, we also obtained and reviewed multiple studies of the same data conducted by SEC's Office of Economic Analysis (OEA).

We also compared total new FTD in threshold securities listed on the NYSE, NASDAQ, and Amex with consolidated trading volume on those exchanges. We obtained consolidated trading volume data for all three exchanges from the Financial Industry Regulatory Authority (FINRA). In addition, we compared trends in FTD in these markets with trends in volatility, as measured by the Chicago Board Options Exchange (CBOE) Volatility Index (VIX); market performance, as measured by the S&P 500 Total Return Index; and short interest. We obtained the VIX from Yahoo! Finance, the S&P 500 Total Return Index from Global Insight, and short interest from the midmonth short interest press releases from the three major exchanges. We did not conduct an assessment of the reliability of these measures. However, these sources are widely used in both finance and economics and are considered credible for the purposes in which we used them. In addition, these measures are used solely for descriptive purposes and not for the purpose of making recommendations or drawing conclusions about causality. We also identified the percentage of threshold securities in our review period that were exchange-traded funds (ETF). To identify these securities, we downloaded lists of ETFs from four separate sources—including Morningstar, Yahoo! Finance, MSN Money, and Bloomberg—and compared these lists to identify any differences. We found that differences between the sources amounted to less than 3 percent of ETFs appearing on each respective list. To have the most comprehensive list, we included ETFs that appear on at least three of these four sources. We have determined that these data were reliable for our purpose, which was to provide descriptive information.

To discuss regulatory, industry, and other market participant views on the effectiveness of Regulation SHO and the recent emergency orders in curbing the potential for manipulative naked short selling, we reviewed and analyzed the requirements of Regulation SHO, the recent emergency orders, the temporary rule, and comment letters submitted to SEC. We also reviewed the results from an OEA study on the impact of the temporary preborrow requirement on the market in the July emergency

order. While we found the results were based on a reasonable methodology, we note that is difficult to draw strong conclusions given a number of limitations, including the temporary nature of the emergency order. We also reviewed two private sector studies to better understand market trends during and after the implementation of the July emergency order. We did not evaluate or validate their findings because these private sector studies were reviewed primarily to provide additional descriptive information beyond the OEA study, and because neither conducted a rigorous causal investigation. In general, the inclusion of the OEA and private sector studies is purely for research purposes and does not imply that we deem them definitive. Furthermore, we obtained and reviewed comment letters submitted to SEC about Regulation SHO, the emergency orders, and the temporary rule. Finally, we conducted interviews with staffs from OEA, Trading and Markets, OCIE, SEC's Division of Enforcement, and FINRA; broker-dealers and two trade associations representing broker-dealers; securities lenders and a trade association representing securities lenders, securities lending consultants; an issuer and a trade association representing issuers; an investor; legal and subject area experts; and other market observers.

To analyze SEC and SRO efforts to enforce industry compliance with Regulation SHO and to detect manipulative naked short selling, we reviewed a 2005 joint sweep examination that OCIE, NYSE, and the former NASD conducted. We obtained data from FINRA and CBOE on the number of Regulation SHO-related examinations that they conducted during calendar years 2005 through 2008, and the number of these examinations that resulted in Regulation SHO deficiencies. We conducted a data reliability assessment of the FINRA and CBOE data and determined they were reliable for our purpose. We also reviewed FINRA data on the periodic surveillance sweeps of FTD data that the authority conducted during this period to monitor its members for potential Regulation SHO violations. We obtained data from OCIE on the oversight and cause examinations conducted from January 1, 2005, through September 30, 2008, that reviewed for Regulation SHO compliance. We conducted a data reliability assessment of these data and determined they were reliable for our purpose. From these data, we selected and reviewed 12 OCIE broker-dealer oversight or cause examination reports and 11 FINRA examination reports that resulted in findings of Regulation SHO deficiencies. We also reviewed a 2006 sweep examination conducted by CBOE of its options market makers, FINRA examination guidance, and the revised 1994 Prime Broker Letter. We conducted interviews with staffs from OCIE, Enforcement, FINRA, CBOE, and NYSE, and with broker-dealers and a trade association representing broker-dealers.

To discuss industry experience regarding the implementation of the new and enhanced close-out requirements, we reviewed industry comment letters submitted to SEC, documentation related to SRO requests to SEC for guidance, and the *2004-2009 Strategic Plan*. We also interviewed broker-dealers and a trade association representing broker-dealers; securities lenders and a trade association representing securities lenders; securities lending consultants; and staff from Trading and Markets and an SRO.

We conducted this performance audit from March 2008 through May 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Clearing Agencies Settle Equity Securities Trades through a 3-Day Settlement Cycle and Continuous Net Settlement

According to the Depository Trust and Clearing Corporation (DTCC), most broker-to-broker equities securities trades in the United States are cleared and settled through its clearing agency subsidiaries, NSCC and the Depository Trust Company (DTC). As a clearing corporation, NSCC provides clearing and settlement, risk management, central counterparty services, and guarantee of trade completion in the event of a participant's default. As the central security depository and custodian in the United States, DTC acts as a custodian for the majority of securities issues and transfers ownership, in book-entry form, during settlement.

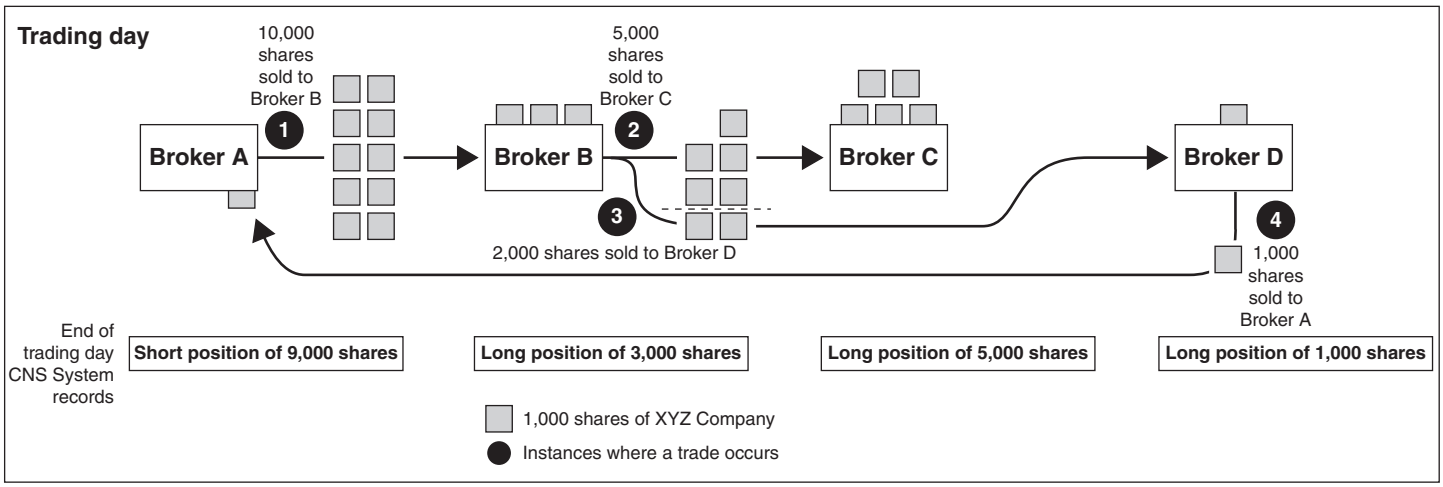
Due to the volume and value of trading in today's markets, NSCC nets trades and payments among its participants, using its Continuous Net Settlement System (CNS System). The CNS System is a book-entry accounting system in which each NSCC participant's daily purchases and sales of securities, based on trade date, are automatically netted into one long position (right to receive) or one short position (obligation to deliver) for each securities issue purchased or sold.[1] The participant's corresponding payment obligations are similarly netted into one obligation to pay or one obligation to receive money.[2] For each participant with a short position on settlement date, NSCC instructs the securities depository designated by the participant—typically, DTC—to deliver securities from the participant's account at the depository to NSCC's account. NSCC then instructs the depository to deliver those securities from NSCC's account to participants with net long positions in the security. NSCC provides participants with multiple daily reports that detail their net long and short positions in each security. One example of such a report is the CNS Accounting Summary, which provides NSCC participants with its prior day's positions, settling trades during the day, closing positions, and the market value of its positions. Any unfulfilled net long or short position in a settlement cycle is carried forward to succeeding settlement cycles.

Figures 10 and 11 illustrate the CNS process. Figure 10 illustrates a series of transactions between multiple brokers and the resulting CNS position.

[1]CNS positions do not represent ownership. Only DTC account positions represent ownership.

[2]According to NSCC, the CNS System reduces the value of securities and payments that need to be exchanged by an average of 98 percent each day.

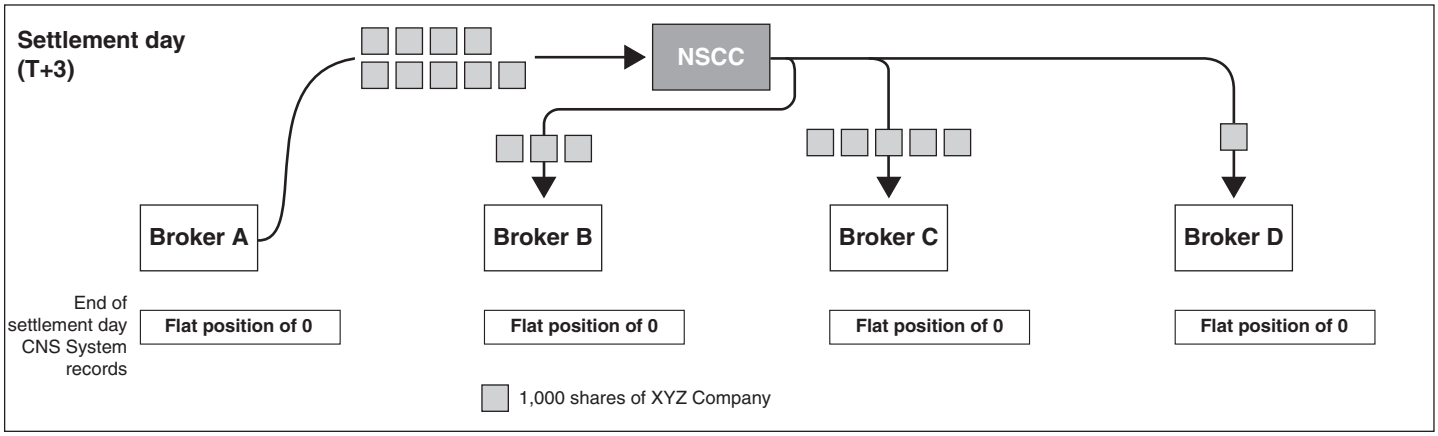
Figure 10: Trading Day Transactions and Broker CNS Positions



Sources: SEC (data); GAO (analysis).

Figure 11 illustrates the transactions that occur on settlement day and the resulting CNS positions. This example assumes that the brokers shown in the graphic executed no other trades in the XYZ Company's security.

Figure 11: Settlement Day and Broker CNS Positions



Sources: SEC (data); GAO (analysis).

If a participant fails to deliver the total number of securities that it owes NSCC on a particular settlement date, NSCC may be unable to meet its delivery obligations, resulting in a failures to receive (FTR) for participants who have net long positions. NSCC uses the automated Stock

Borrow Program (SBP) to borrow shares to meet as many of its delivery obligations as possible. This program allows participants to instruct NSCC on the specific securities from their DTC account that are available for borrowing to cover NSCC's CNS delivery shortfalls. Any shares that NSCC borrows are debited from the lending participant's DTC account; delivered to NSCC; and, subsequently, delivered to a NSCC participant with a net long position. NSCC creates a right to receive (net long) position for the lender in the CNS System to show that it is owed securities. Until the securities are returned, the lending participant no longer has ownership rights in them and, therefore, cannot relend them. Additionally, any delivery made using the SBP does not relieve the participant that fails to deliver from its delivery obligation to NSCC.

Participants with a FTR position not filled through the SBP have three options for receiving the securities they are owed. First, the participant can choose to wait for the CNS System to allocate the securities that it is owed through the normal course of business.[3] Second, the participant can request that NSCC give its FTR priority in the CNS System. This allows the participant's FTR position to be filled with any securities NSCC receives after all buy-in requests are fulfilled, but before CNS begins allocating received shares to other participants with net long positions in the security.[4] Third, the participant can initiate a buy-in.[5] This process requires the participant to file paperwork with NSCC directing the corporation to request a net short participant to deliver securities to NSCC and for NSCC to deliver those securities to the net long participant. If the position remains unfilled, NSCC instructs the member to buy-in the unfilled position. NSCC has no authority under SEC rules to force a buy-in. DTCC

[3]The fact that a participant 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 participant's FTR is cured. Under Article 8 of the Uniform Commercial Code, a securities broker-dealer may credit a customer's account with a security even though that security has not yet been delivered to the broker-dealer's account at DTC by NSCC. In that event, the customer receives what is defined under the 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.

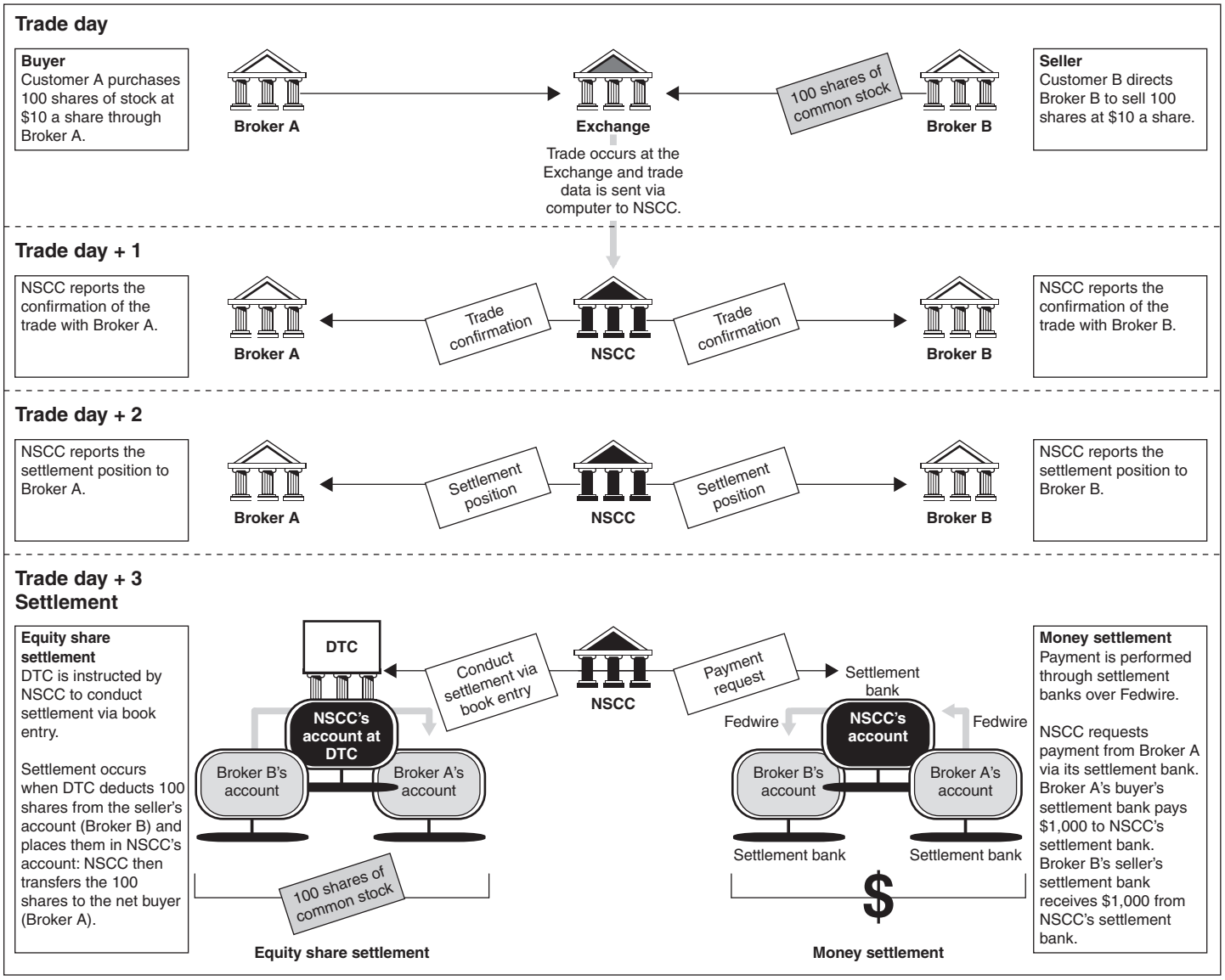
[4]NSCC employs an algorithm to allocate shares to participants with net short positions. The algorithm is based on priority groups in descending order, the age of position within priority groups, and random numbers within age groups.

[5]A buy-in occurs when the seller does not deliver the securities on time, and the buyer is forced to obtain the securities elsewhere (e.g., by purchasing them in the open market). The costs of conducting the buy-in, including any transaction costs and difference in the price of the security, generally are passed to the seller.

officials explained to us that approximately 6,000 notices of intention to buy-in are filed each day, with approximately 20 notices resulting in execution. According to these officials, relatively few such notices are executed because FTD are generally resolved in the normal course of business.

Trade clearance and settlement in the United States operate on a standard 3-day settlement cycle. On trade date (T), trade details are transmitted to NSCC for processing. According to DTCC, an estimated 99.9 percent of equity transactions are transmitted to the clearing agency as "locked-in," meaning that the security exchange has already compared the buyer's account with the seller's account of the trade details (e.g., share quantity, price, and security) and has determined that they match. On the first day following the trade date (T+1), NSCC assumes the role of central counterparty by taking on the buyer's credit risk and the seller's delivery risk. On the second day (T+2), NSCC provides summaries of all compared trades to its participant broker-dealers, including information on the net positions of each security due or owed for settlement. On the third day (T+3), securities are delivered and payments of money are made to the respective parties through NSCC and DTC. Figure 12 summarizes the clearance and settlement process for equity securities trades in the United States.

Figure 12: Clearance and Settlement Process for Equity Securities Trades in the United States



Sources: NSCC (data), GAO (analysis), and Art Explosion (images).

Appendix III: Additional Trend Data on FTD in Threshold Securities, and All Equity Securities

SEC has taken several actions in recent years that were intended to address FTD and manipulative naked short selling. In August 2004, SEC adopted Regulation SHO, which was intended to address large and persistent FTD and curb the potential for manipulative naked short selling.[1] Among other things, Regulation SHO imposed delivery requirements on broker-dealers for equity securities in which a substantial amount of FTD had occurred, which the regulation designated as "threshold securities." Regulation SHO required broker-dealers that have FTD in these securities lasting for 10 consecutive days to "close out" the FTD by purchasing securities of like kind and quantity in the market by the beginning of regular trading hours, the next morning (T+14), with some exceptions.[2] In July 2008, SEC issued an emergency order (July emergency order) to temporarily restrict naked short selling and FTD in the publicly traded securities of 19 large financial firms, with limited exceptions. In September 2008, SEC took more comprehensive action to curb the potential for manipulative naked short selling when it issued another emergency order (September emergency order) that temporarily enhanced close-out requirements on the sale of all equity securities. The September emergency order required broker-dealers to deliver securities resulting from short sales in any equity security (not just threshold securities) by the settlement date (T+3), or, if they have FTD on the settlement date, to take action to purchase or borrow securities to close out the FTD by the beginning of regular trading hours the next morning (T+4), with limited exceptions.[3] Broker dealers that can show that the FTD resulted from a long sale were allowed until the beginning of regular trading hours on T+6 to close out the FTD.[4] Upon expiration of the emergency order, SEC extended this temporary requirement until July 31, 2009, as part of the interim final temporary rule (temporary rule).

Figures 13 through 24 illustrate the trends in threshold securities and their FTD between the effective date of Regulation SHO in January 2005

[1] 69 Fed. Reg. 48008 (Aug. 6, 2004).

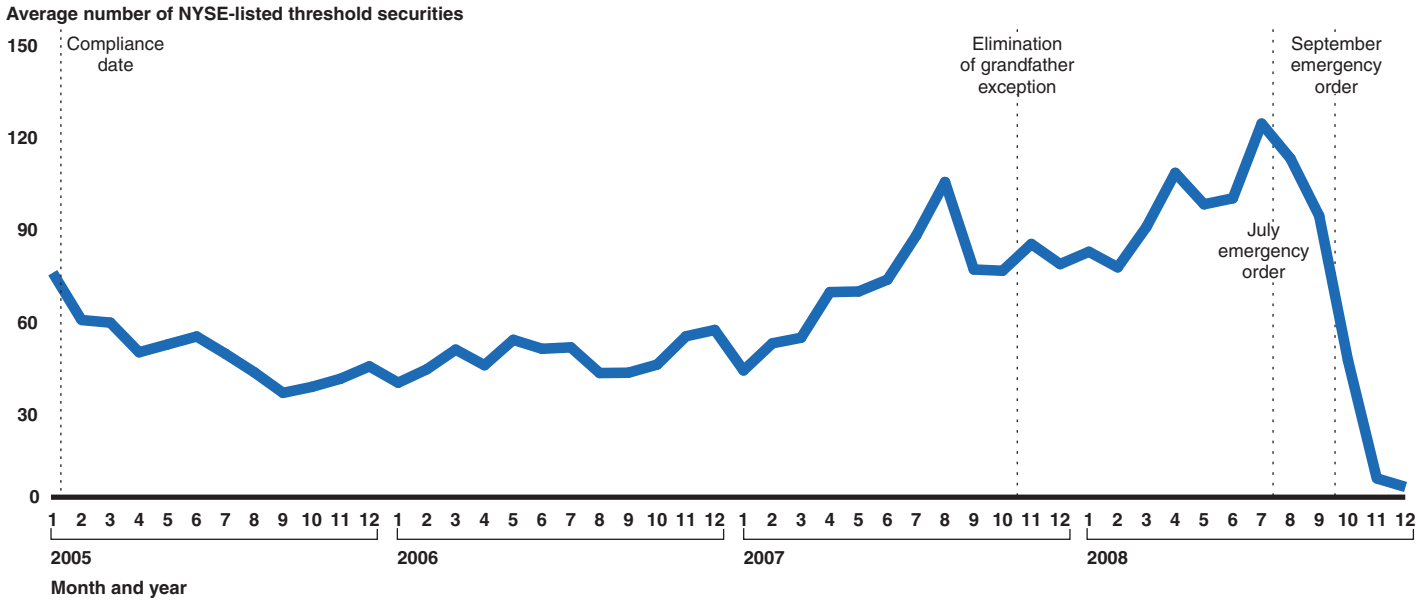
[2] For example, SEC stated that the close-out requirement did not apply to any FTD that were established prior to the security becoming a threshold security. SEC termed this exception the grandfather exception. However, after later considering data showing that substantial and persistent FTD in a small number of threshold securities were not being closed out due to reliance on the grandfather exception, SEC amended Regulation SHO in August 2007 to eliminate the exception.

[3] 73 Fed. Reg. 54875 (Sept. 23, 2008).

[4] A "long sale" is the sale of securities in which the seller owns the securities that were sold.

through December 2008, by the market on which these securities were trading. These markets include the New York Stock Exchange (NYSE), NASDAQ, and the American Stock Exchange (Amex). We have also generated trends for threshold securities trading on NYSE Arca, the Over-The-Counter Bulletin Board (OTCBB), and Pink Quote under the "Other Securities" category.[5] We also generated trends in FTD in all securities (both threshold and nonthreshold), by market, over the review period (figs. 25 through 36).

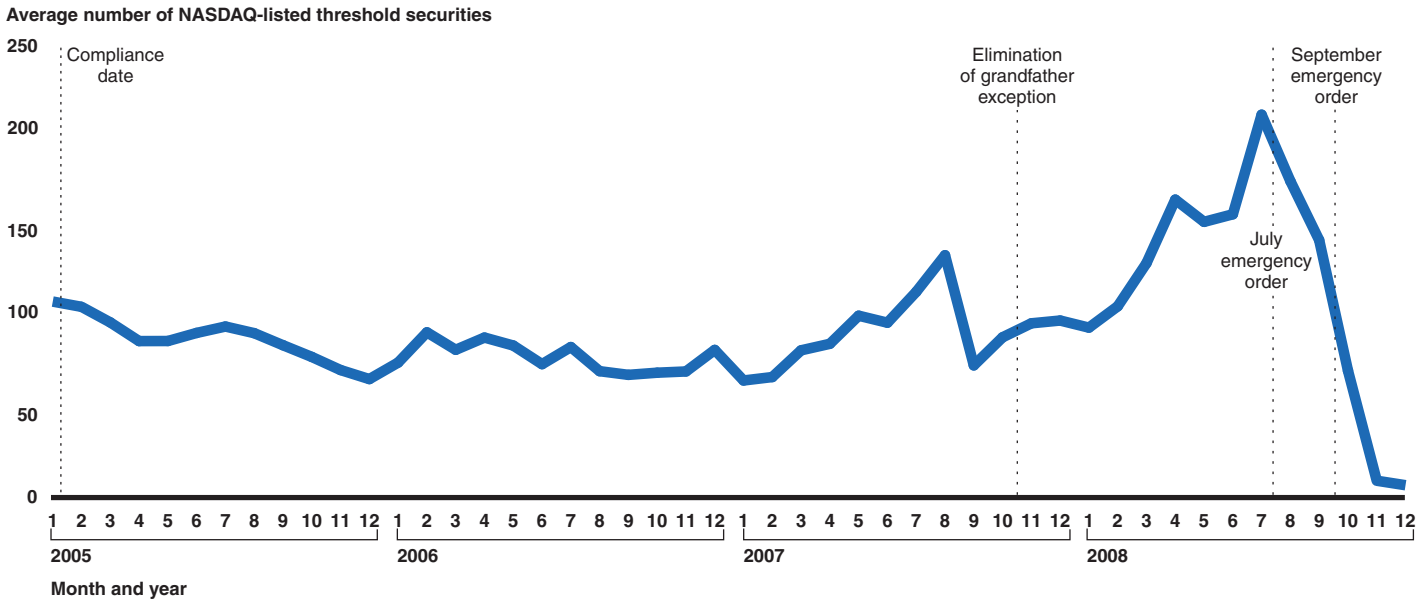
Figure 13: Average Number of NYSE-listed Threshold Securities, per Month, by Number of Days on the Threshold List, from January 2005 through December 2008



Sources: SEC (data); GAO (analysis).

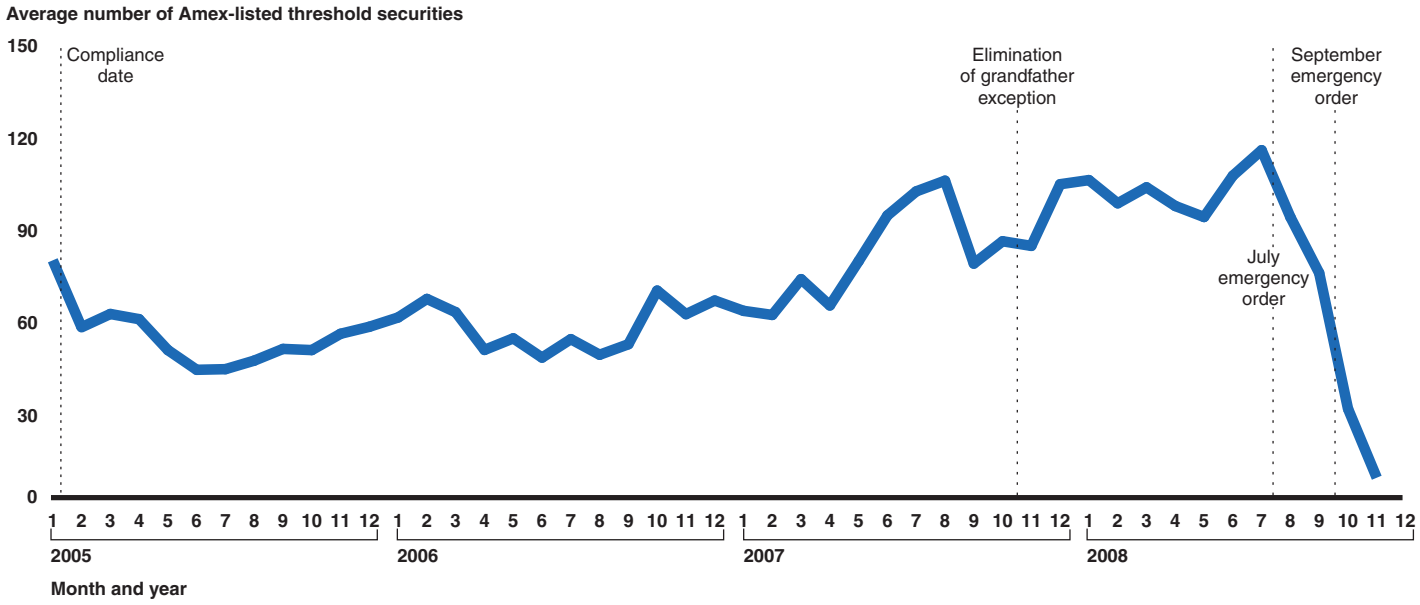
[5]OTCBB is a regulated electronic trading service that shows real-time quotes, last-sale prices, and volume information for over the counter (OTC) equity securities. Pink OTC Markets, Inc., operates Pink Quote (formerly known as Pink Sheets), an electronic quotation system that displays quotes from many broker-dealers for many OTC securities. Broker-dealers use Pink Quote to publish their bid and ask prices of OTC stocks. There are no listing requirements for a company to start trading on OTCBB or Pink Quote.

Figure 14: Average Number of NASDAQ-listed Threshold Securities, per Month, by Number of Days on the Threshold List, from January 2005 through December 2008



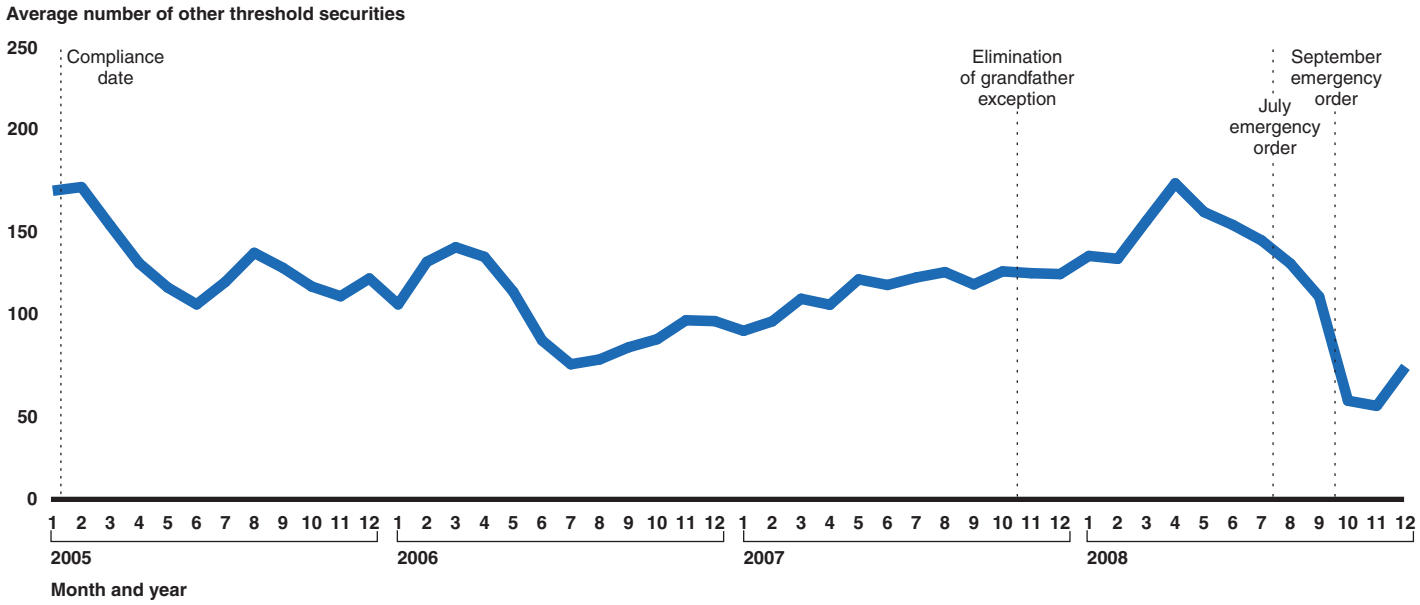
Sources: SEC (data); GAO (analysis).

Figure 15: Average Number of Amex-listed Threshold Securities, per Month, by Number of Days on the Threshold List, from January 2005 through December 2008



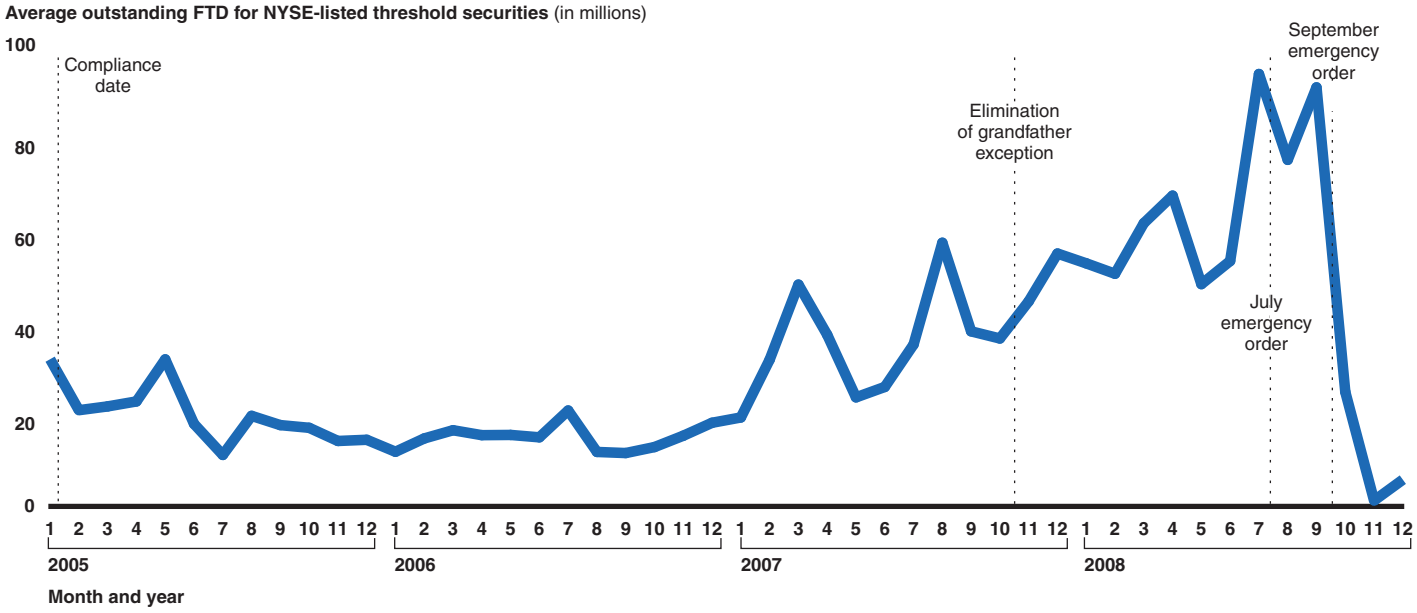
Sources: SEC (data); GAO (analysis).

Figure 16: Average Number of Other Securities, per Month, by Number of Days on the Threshold List, from January 2005 through December 2008



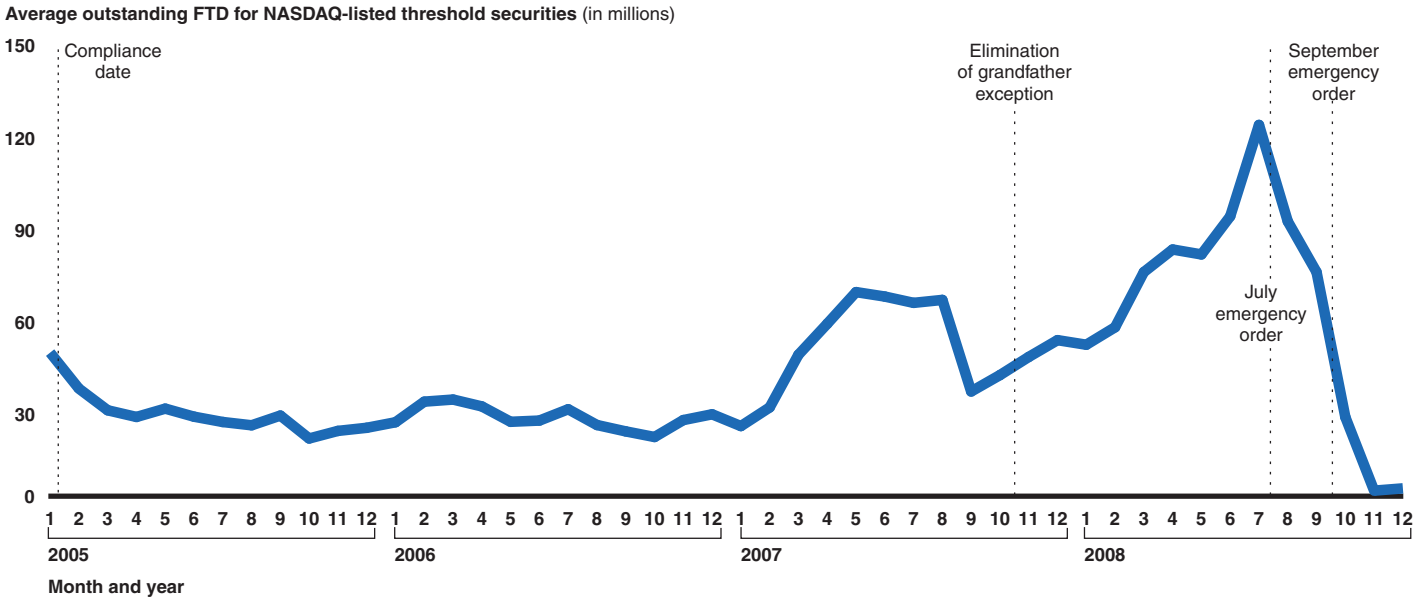
Sources: SEC (data); GAO (analysis).

Figure 17: Average Outstanding FTD, per Month, for NYSE-listed Threshold Securities, from January 2005 through December 2008



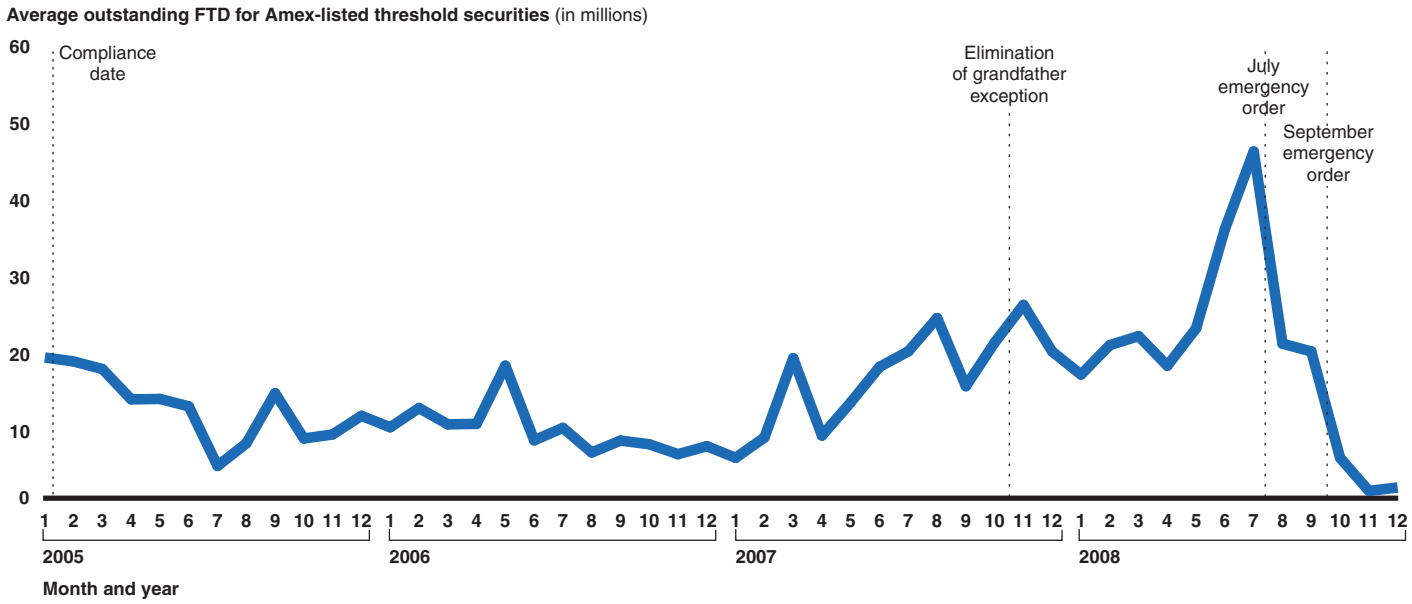
Sources: SEC (data); GAO (analysis).

Figure 18: Average Outstanding FTD, per Month, for NASDAQ-listed Threshold Securities, from January 2005 through December 2008



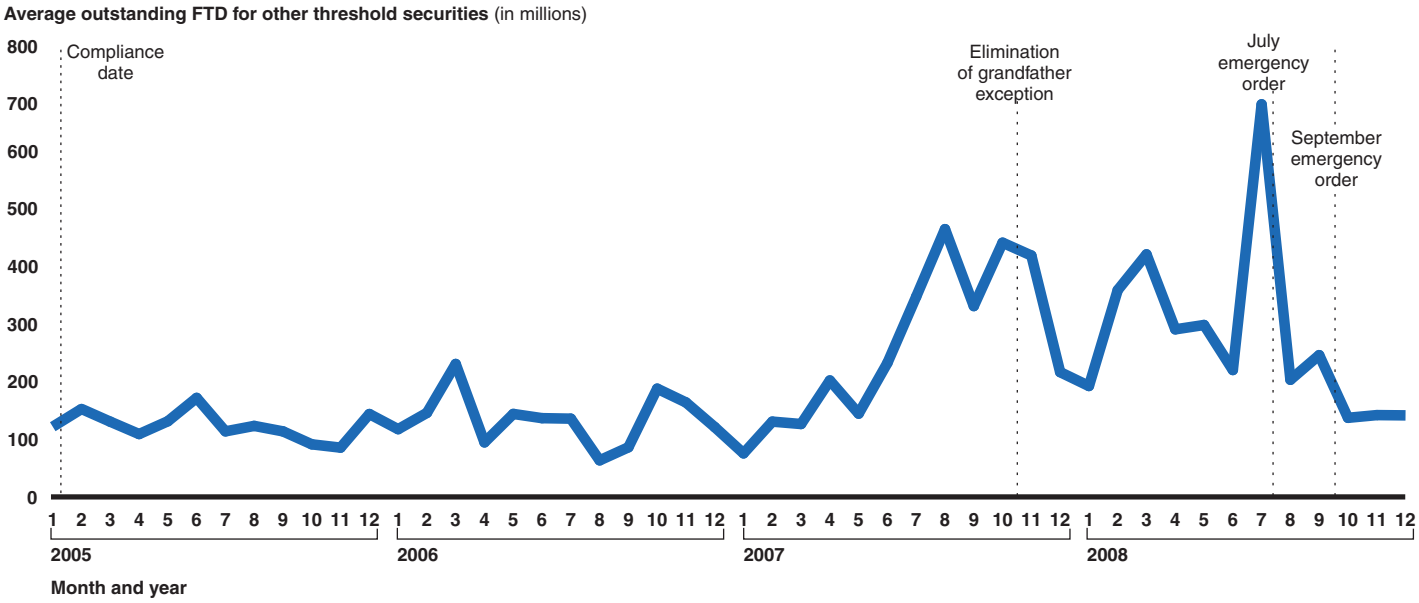
Sources: SEC (data); GAO (analysis).

Figure 19: Average Outstanding FTD, per Month, for Amex-listed Threshold Securities, from January 2005 through December 2008



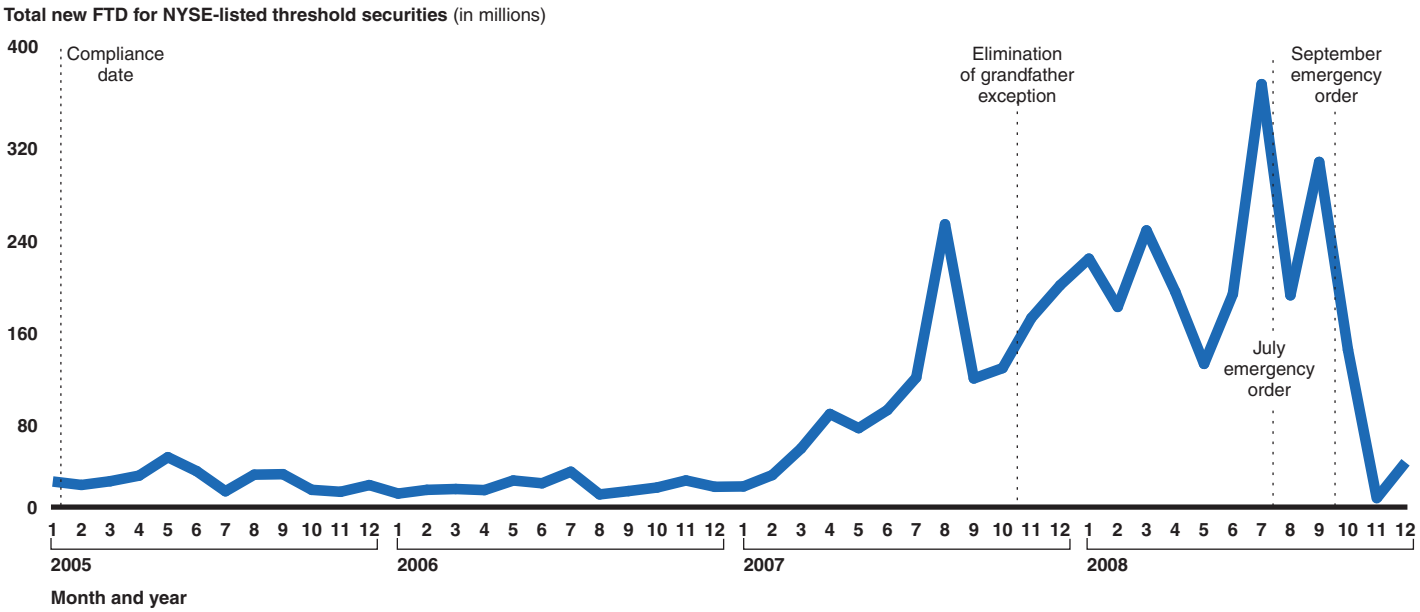
Sources: SEC (data); GAO (analysis).

Figure 20: Average Outstanding FTD, per Month, for Other Threshold Securities, from January 2005 through December 2008



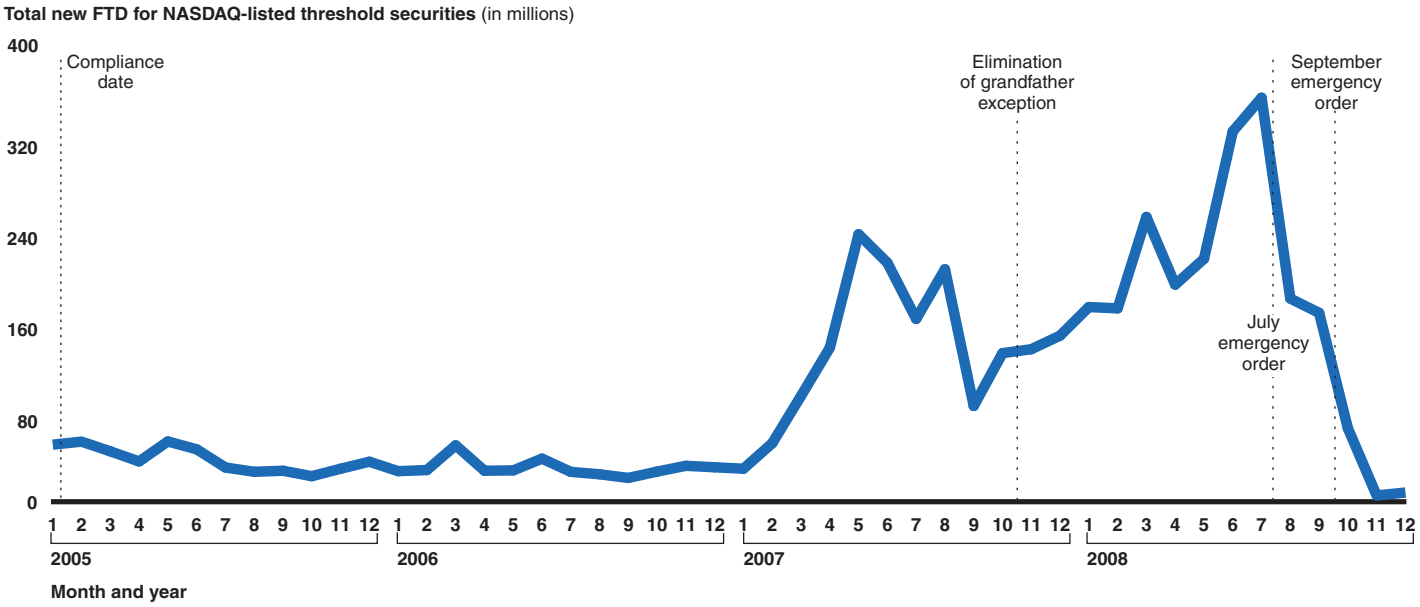
Sources: SEC (data); GAO (analysis).

Figure 21: Total New FTD, per Month, for NYSE-listed Threshold Securities, from January 2005 through December 2008



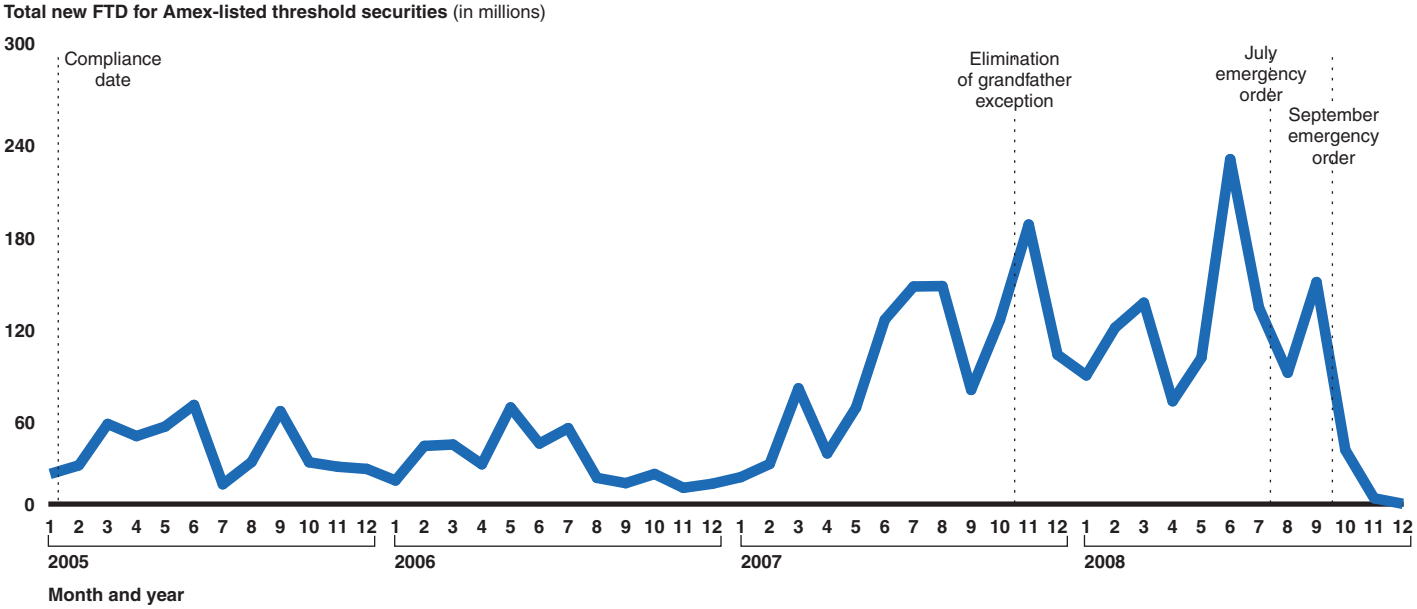
Sources: SEC (data); GAO (analysis).

Figure 22: Total New FTD, per Month, for NASDAQ-listed Threshold Securities, from January 2005 through December 2008



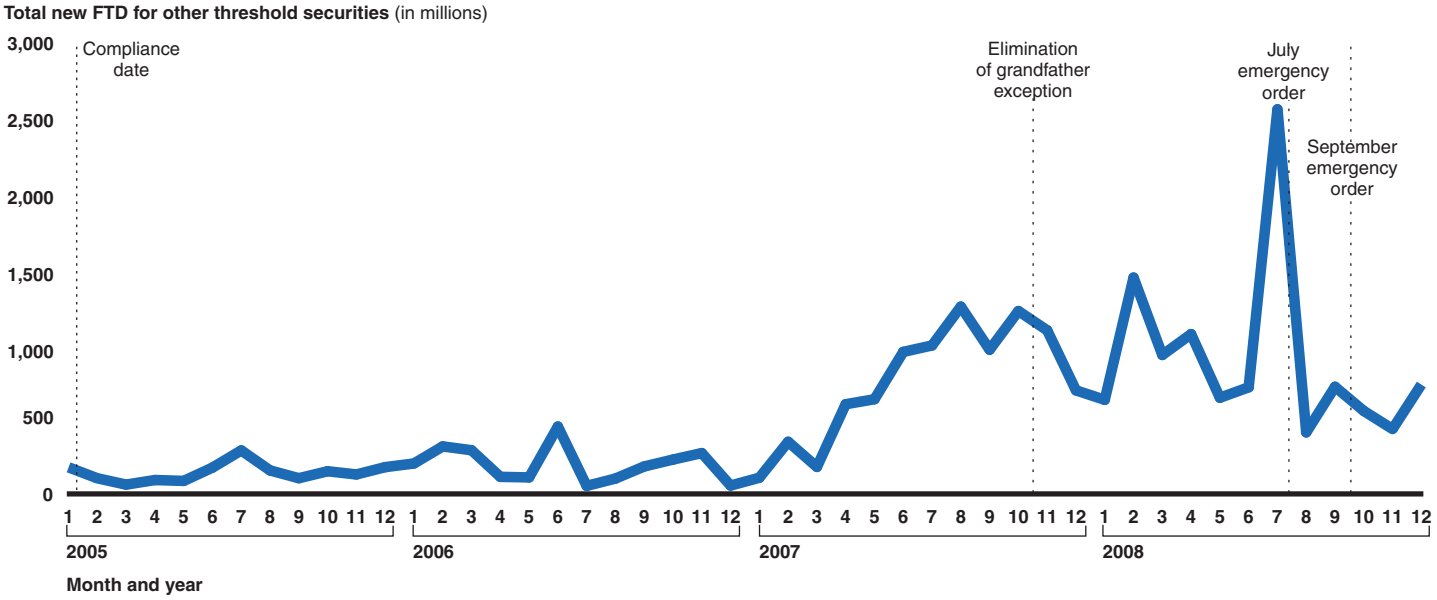
Sources: SEC (data); GAO (analysis).

Figure 23: Total New FTD, per Month, for Amex-listed Threshold Securities, from January 2005 through December 2008



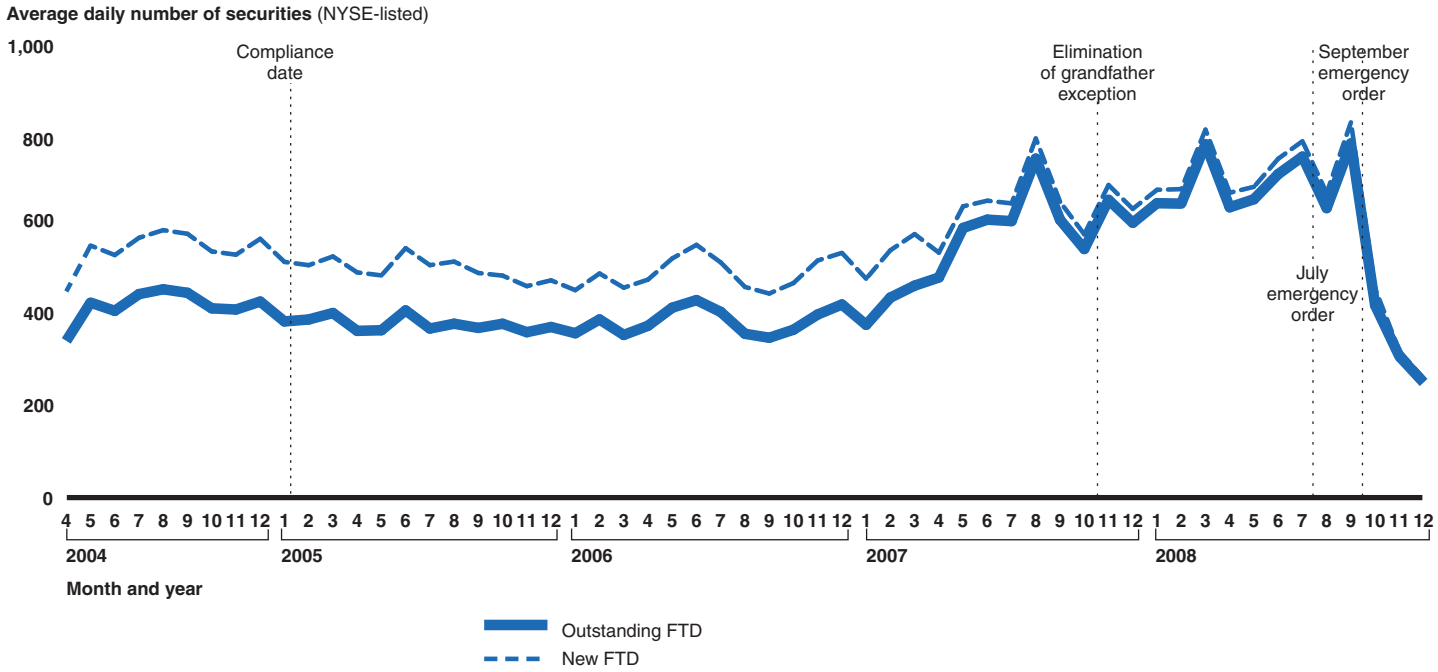
Sources: SEC (data); GAO (analysis).

Figure 24: Total New FTD, per Month, for Other Threshold Securities, from January 2005 through December 2008



Sources: SEC (data); GAO (analysis).

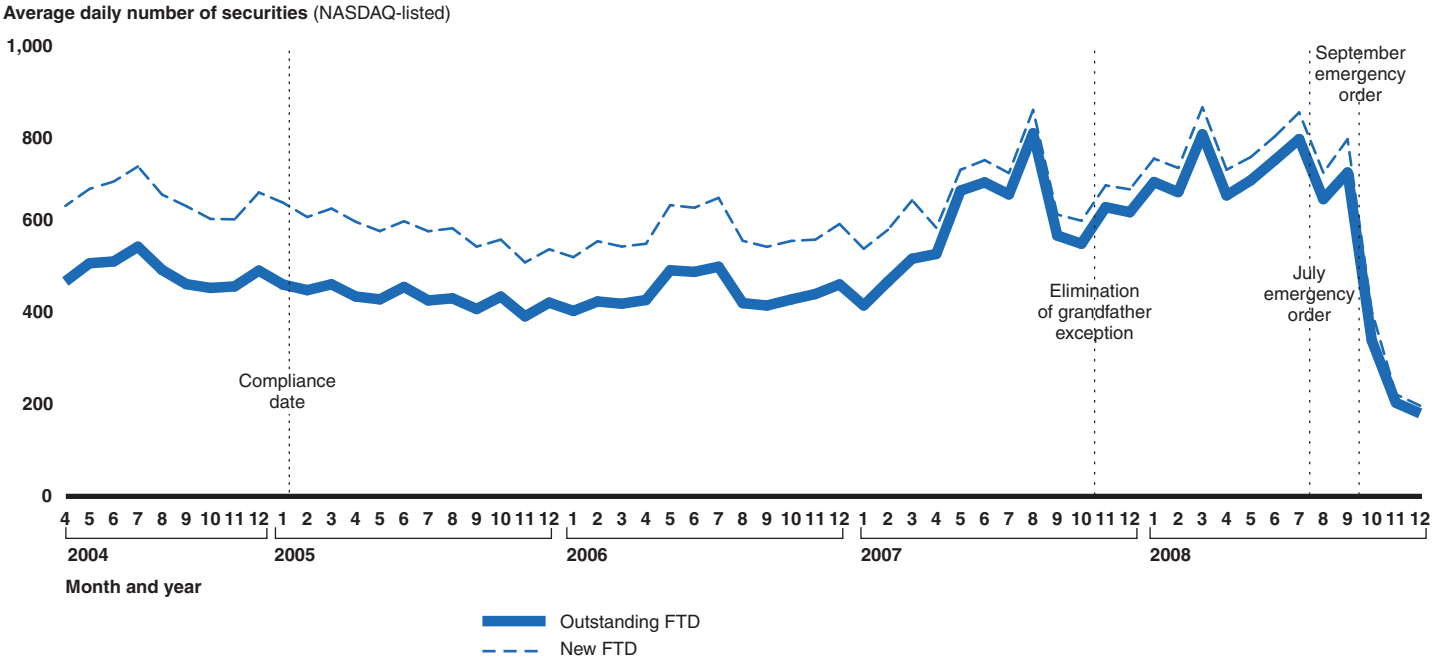
Figure 25: Average Daily Number of Securities with Outstanding and New FTD, per Month, for NYSE-listed Securities, from April 2004 through December 2008



Sources: SEC (data); GAO (analysis).

Note: Prior to September 16, 2008, SEC received FTD data on equity securities with aggregate FTD of 10,000 or more. After this date, SEC began receiving data on all FTD in every equity security. For a consistent comparison, our sample includes securities with aggregate FTD of 10,000 or more for the entire review period.

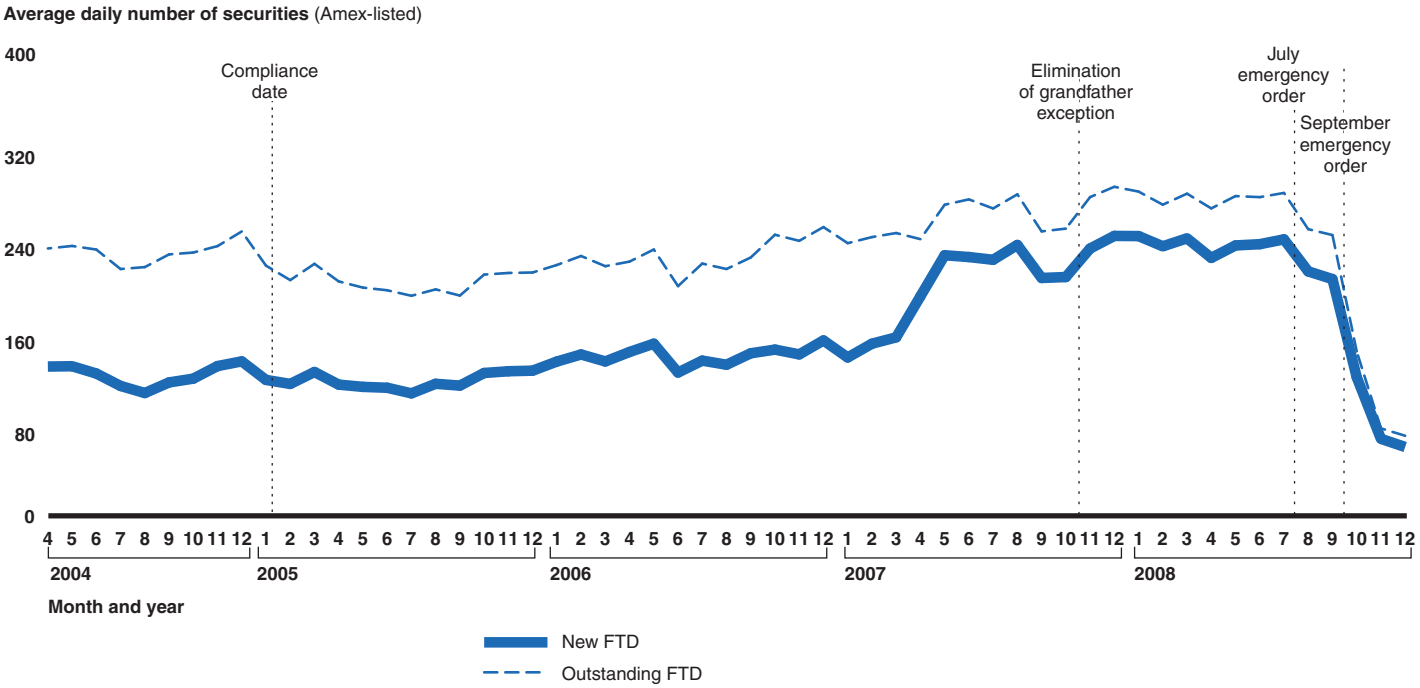
Figure 26: Average Daily Number of Securities with Outstanding and New FTD, per Month, for NASDAQ-listed Securities, from April 2004 through December 2008



Sources: SEC (data); GAO (analysis).

Note: Prior to September 16, 2008, SEC received FTD data on equity securities with aggregate FTD of 10,000 or more. After this date, SEC began receiving data on all FTD in every equity security. For a consistent comparison, our sample includes securities with aggregate FTD of 10,000 or more for the entire review period.

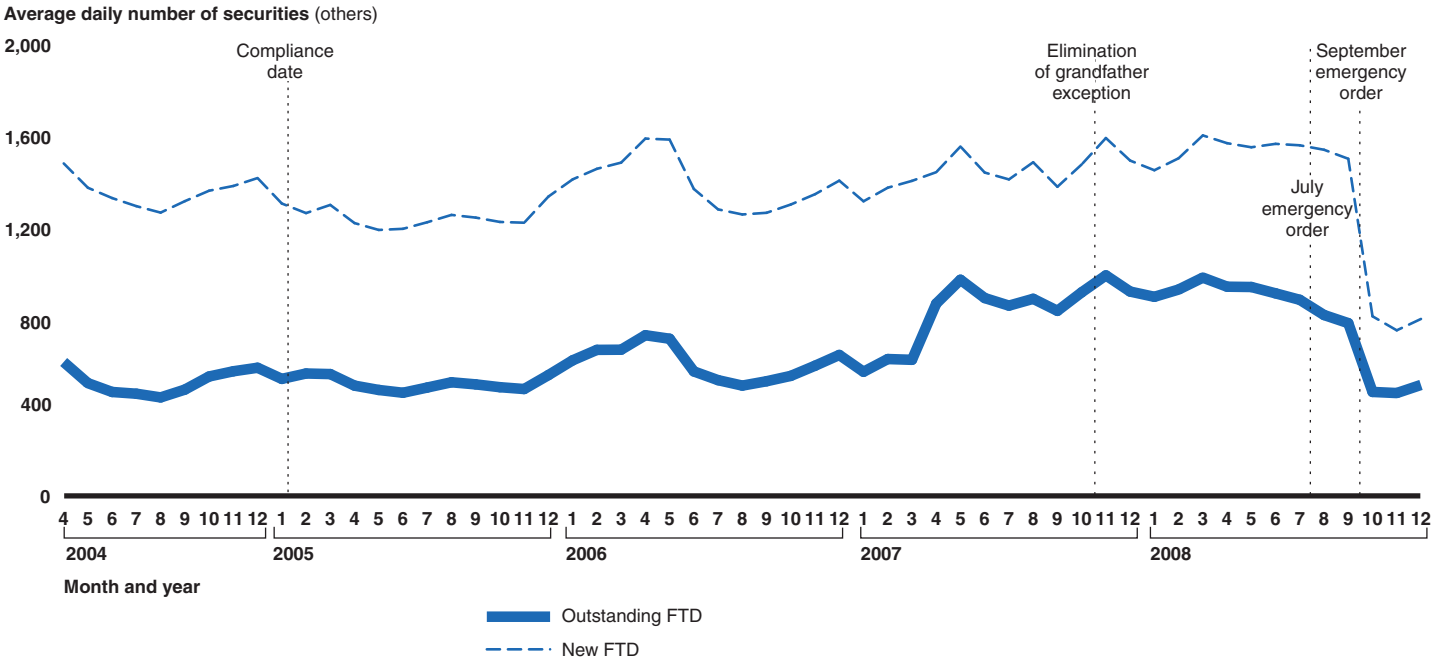
Figure 27: Average Daily Number of Securities with Outstanding and New FTD, per Month, for Amex-listed Securities, from April 2004 through December 2008



Sources: SEC (data); GAO (analysis).

Note: Prior to September 16, 2008, SEC received FTD data on equity securities with aggregate FTD of 10,000 or more. After this date, SEC began receiving data on all FTD in every equity security. For a consistent comparison, our sample includes securities with aggregate FTD of 10,000 or more for the entire review period.

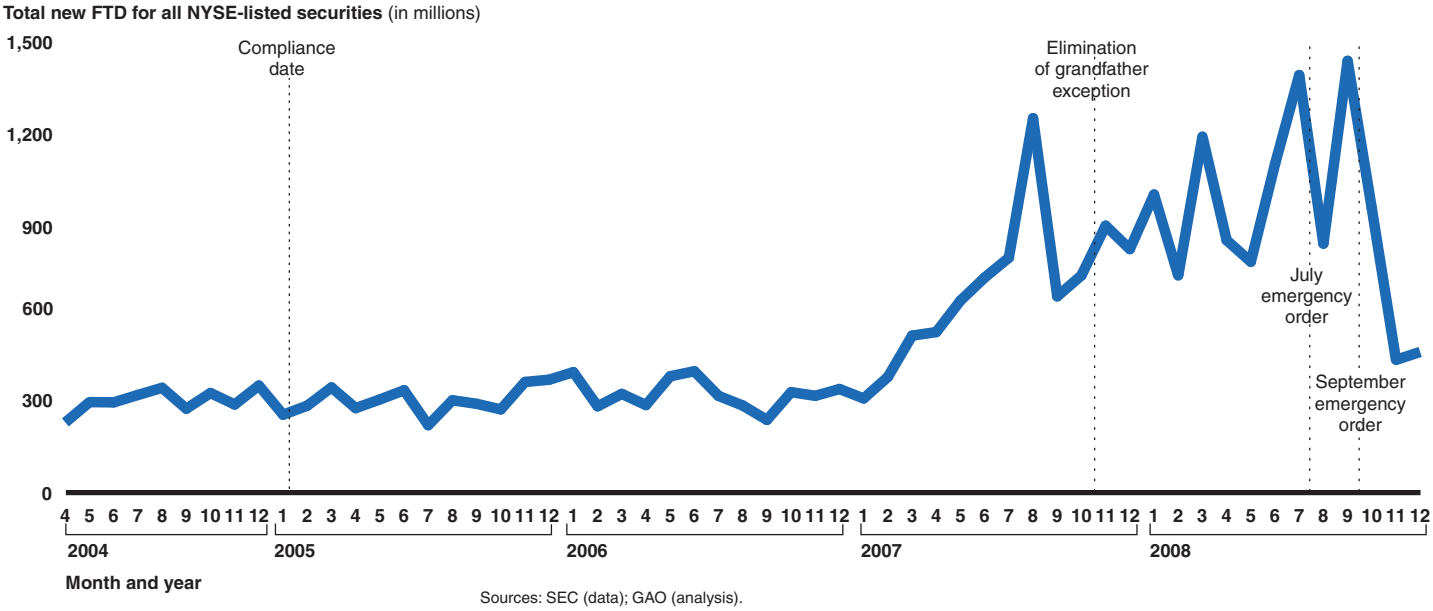
Figure 28: Average Daily Number of Securities with Outstanding and New FTD, per Month, for Other Securities, from April 2004 through December 2008



Sources: SEC (data); GAO (analysis).

Note: Prior to September 16, 2008, SEC received FTD data on equity securities with aggregate FTD of 10,000 or more. After this date, SEC began receiving data on all FTD in every equity security. For a consistent comparison, our sample includes securities with aggregate FTD of 10,000 or more for the entire review period.

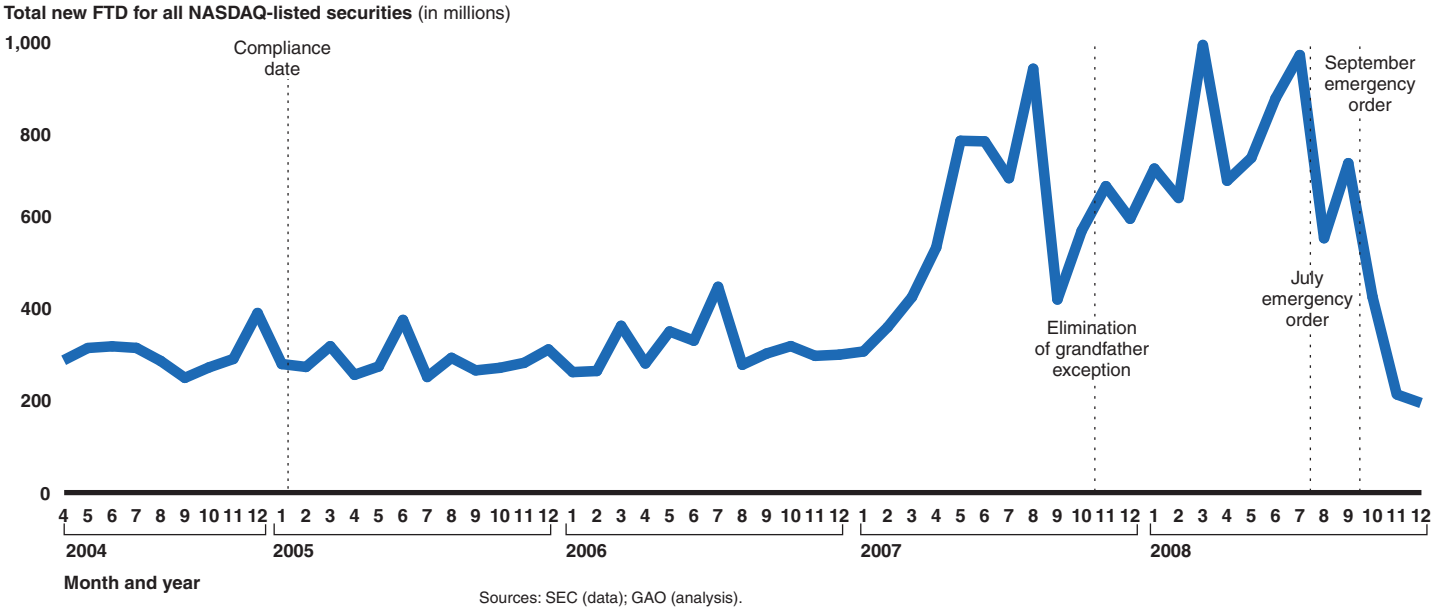
Figure 29: Total New FTD, per Month, for All NYSE-listed Securities, from April 2004 through December 2008



Sources: SEC (data); GAO (analysis).

Note: Prior to September 16, 2008, SEC received FTD data on equity securities with aggregate FTD of 10,000 or more. After this date, SEC began receiving data on all FTD in every equity security. For a consistent comparison, our sample includes securities with aggregate FTD of 10,000 or more for the entire review period.

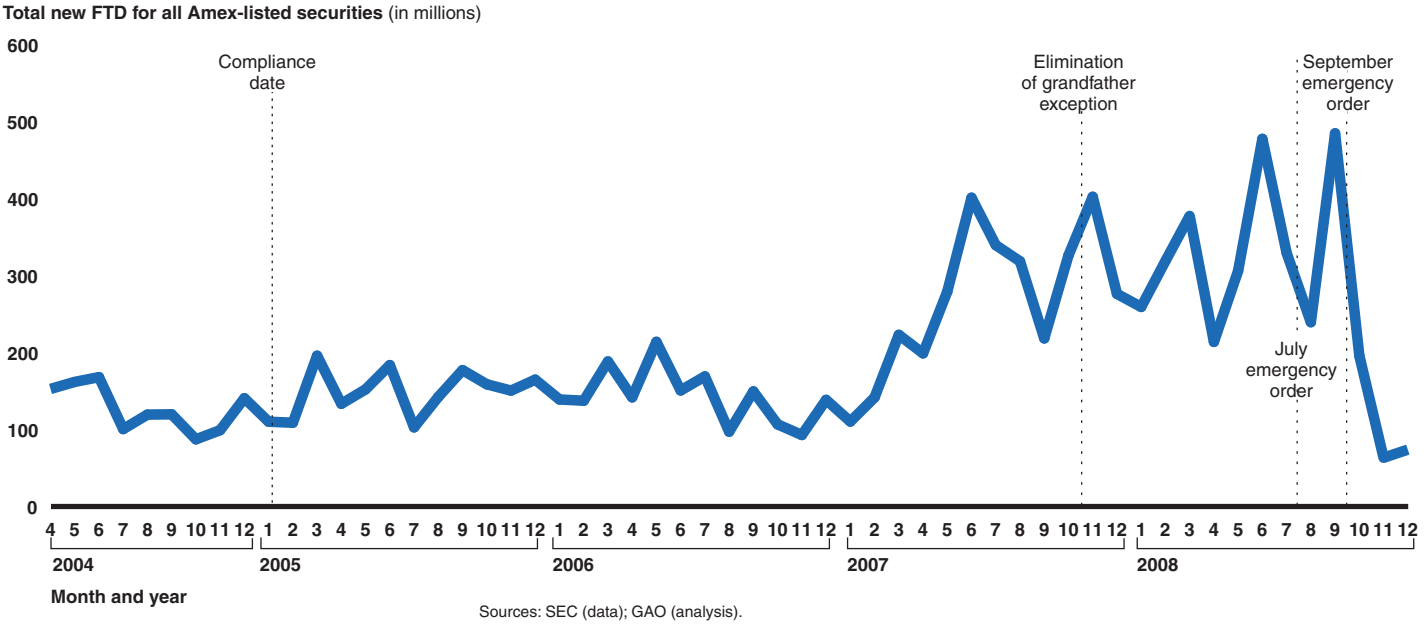
Figure 30: Total New FTD, per Month, for All NASDAQ-listed Securities, from April 2004 through December 2008



Sources: SEC (data); GAO (analysis).

Note: Prior to September 16, 2008, SEC received FTD data on equity securities with aggregate FTD of 10,000 or more. After this date, SEC began receiving data on all FTD in every equity security. For a consistent comparison, our sample includes securities with aggregate FTD of 10,000 or more for the entire review period.

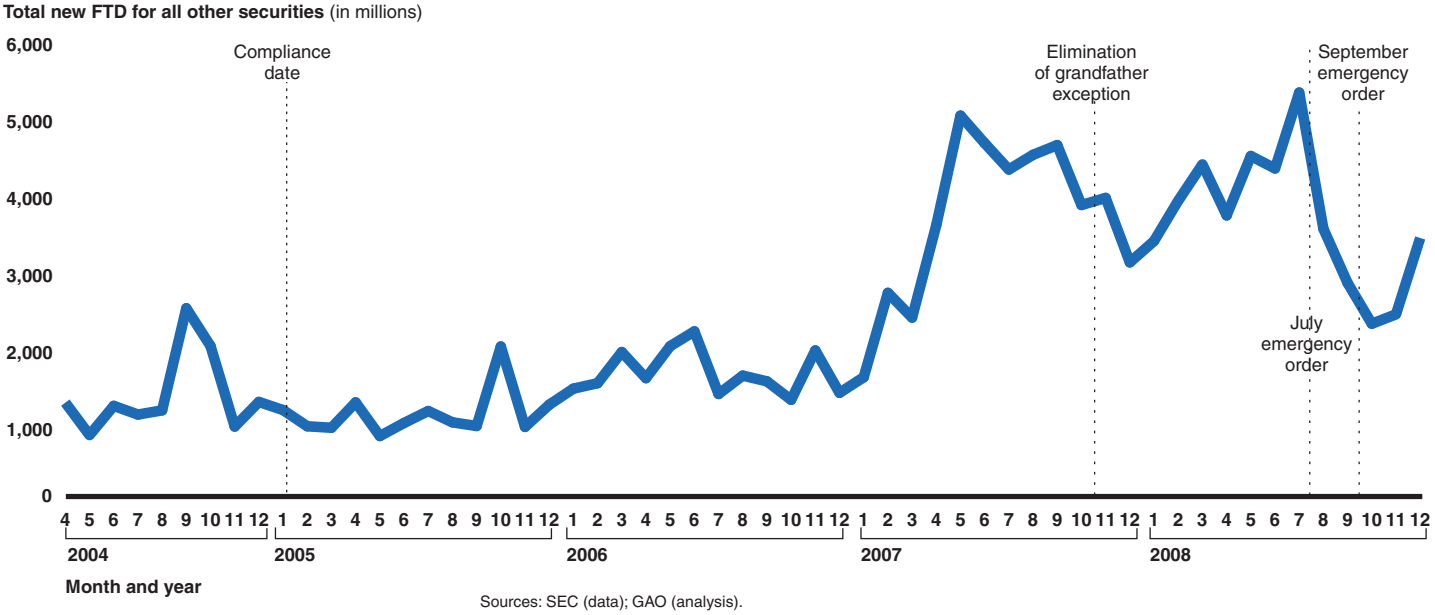
Figure 31: Total New FTD, per Month, for All Amex-listed Securities, from April 2004 through December 2008



Sources: SEC (data); GAO (analysis).

Note: Prior to September 16, 2008, SEC received FTD data on equity securities with aggregate FTD of 10,000 or more. After this date, SEC began receiving data on all FTD in every equity security. For a consistent comparison, our sample includes securities with aggregate FTD of 10,000 or more for the entire review period.

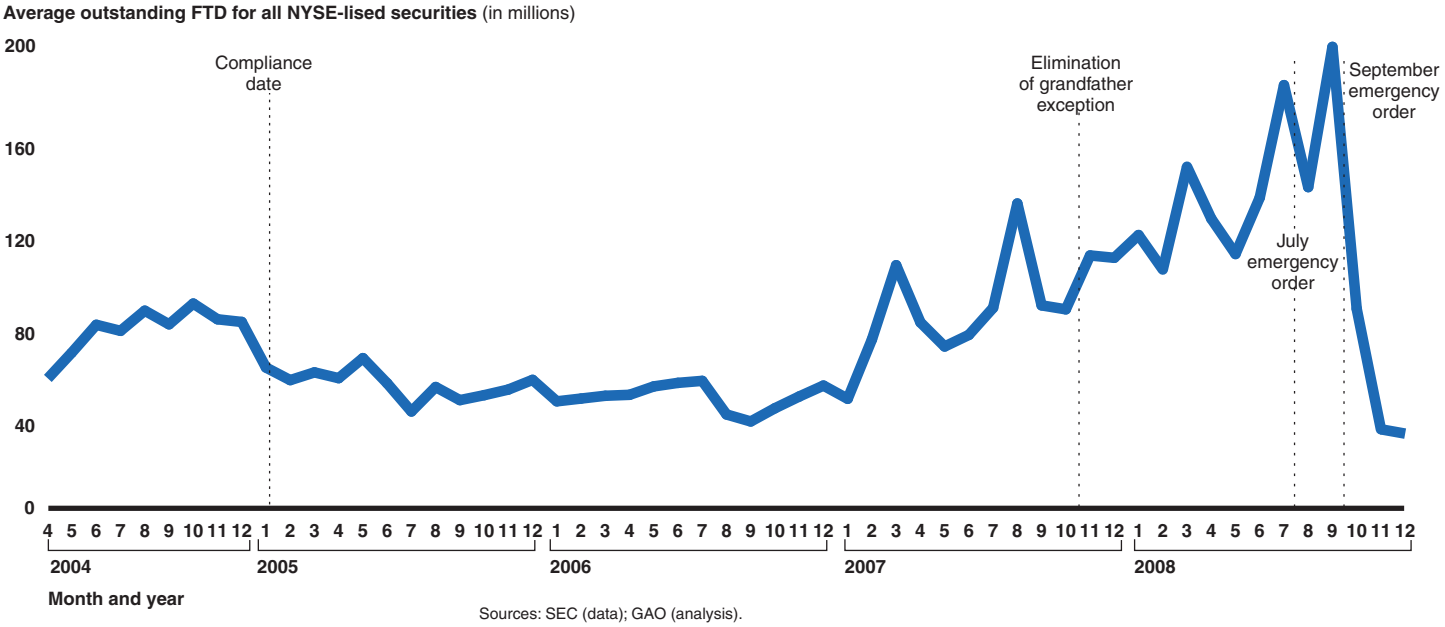
Figure 32: Total New FTD, per Month, for All Other Securities, from April 2004 through December 2008



Sources: SEC (data); GAO (analysis).

Note: Prior to September 16, 2008, SEC received FTD data on equity securities with aggregate FTD of 10,000 or more. After this date, SEC began receiving data on all FTD in every equity security. For a consistent comparison, our sample includes securities with aggregate FTD of 10,000 or more for the entire review period.

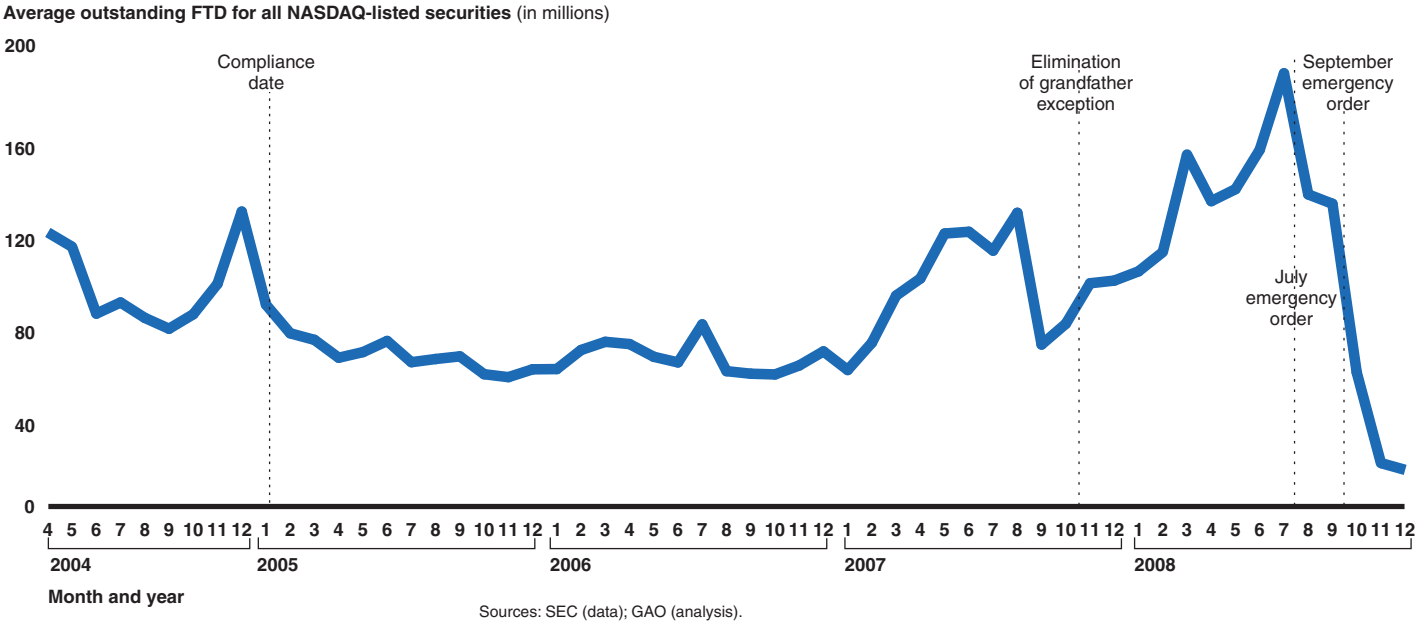
Figure 33: Average Outstanding FTD, per Month, for All NYSE-listed Securities, from April 2004 through December 2008



Sources: SEC (data); GAO (analysis).

Note: Prior to September 16, 2008, SEC received FTD data on equity securities with aggregate FTD of 10,000 or more. After this date, SEC began receiving data on all FTD in every equity security. For a consistent comparison, our sample includes securities with aggregate FTD of 10,000 or more for the entire review period.

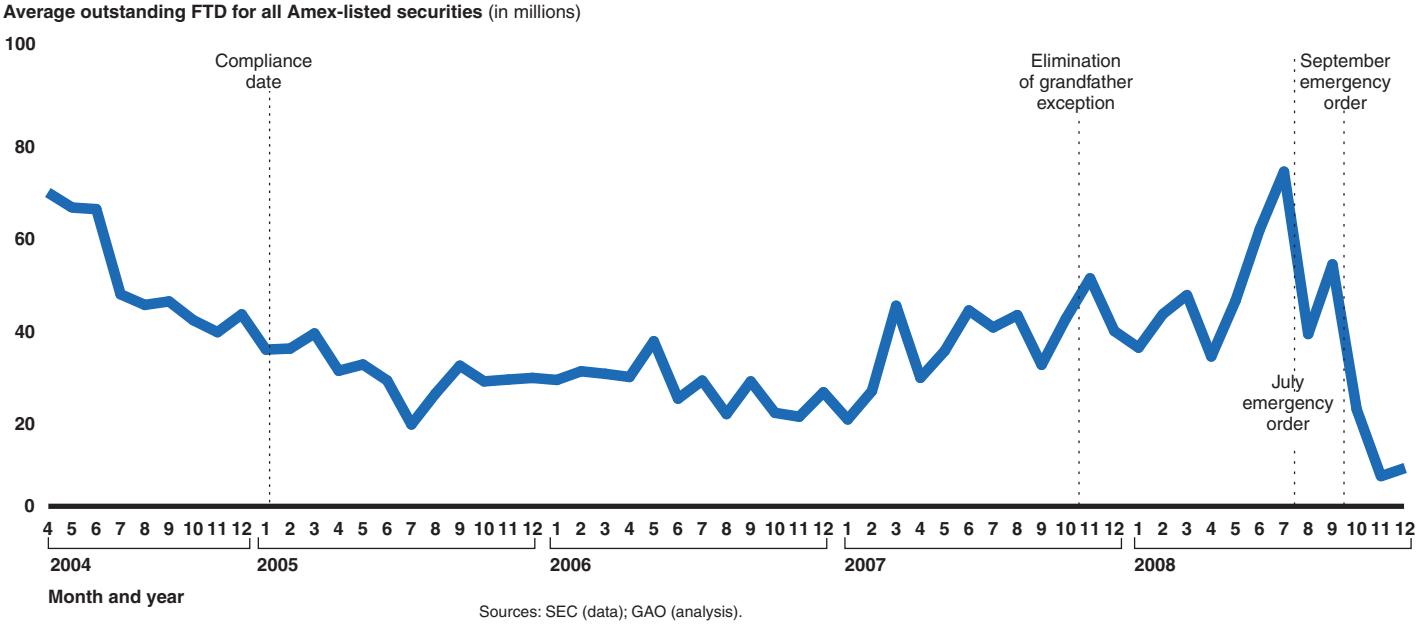
Figure 34: Average Outstanding FTD, per Month, for All NASDAQ-listed Securities, from April 2004 through December 2008



Sources: SEC (data); GAO (analysis).

Note: Prior to September 16, 2008, SEC received FTD data on equity securities with aggregate FTD of 10,000 or more. After this date, SEC began receiving data on all FTD in every equity security. For a consistent comparison, our sample includes securities with aggregate FTD of 10,000 or more for the entire review period.

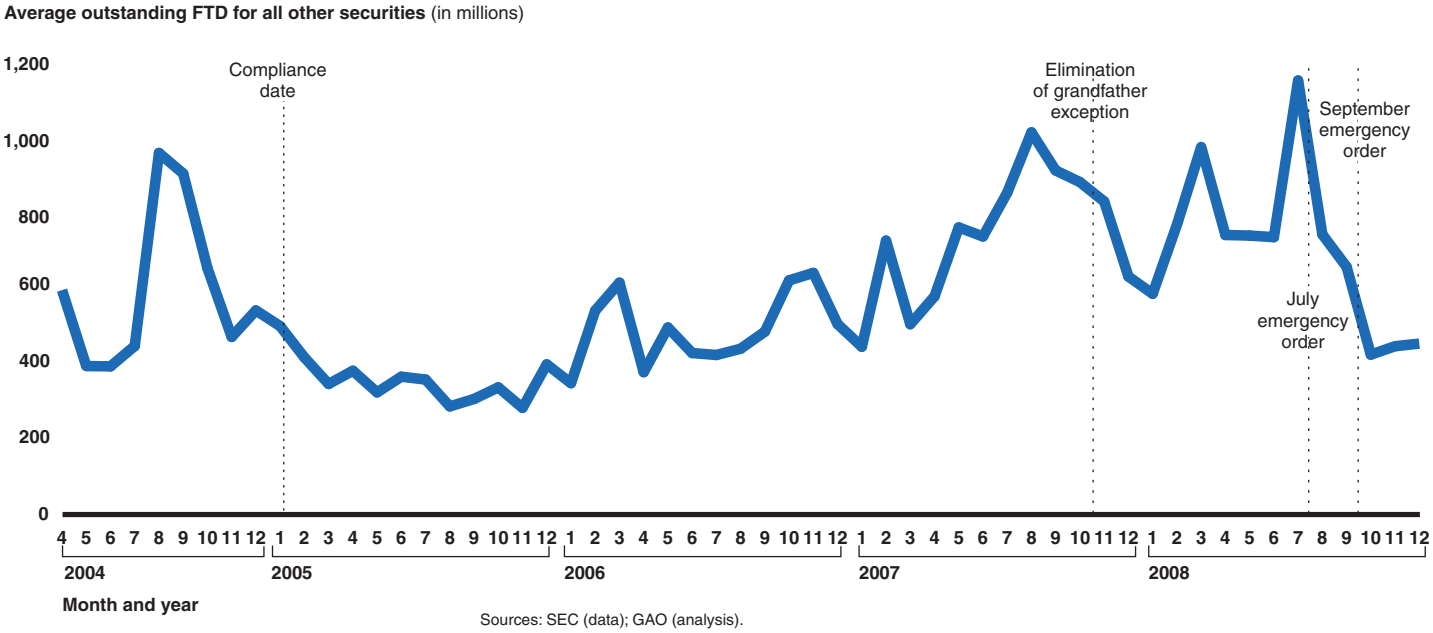
Figure 35: Average Outstanding FTD, per Month, for All Amex-listed Securities, from April 2004 through December 2008



Sources: SEC (data); GAO (analysis).

Note: Prior to September 16, 2008, SEC received FTD data on equity securities with aggregate FTD of 10,000 or more. After this date, SEC began receiving data on all FTD in every equity security. For a consistent comparison, our sample includes securities with aggregate FTD of 10,000 or more for the entire review period.

Figure 36: Average Outstanding FTD, per Month, for All Other Securities, from April 2004 through December 2008



Sources: SEC (data); GAO (analysis).

Note: Prior to September 16, 2008, SEC received FTD data on equity securities with aggregate FTD of 10,000 or more. After this date, SEC began receiving data on all FTD in every equity security. For a consistent comparison, our sample includes securities with aggregate FTD of 10,000 or more for the entire review period.

Appendix IV: Comments from the Securities and Exchange Commission

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

April 30, 2009

Ms. Orice Williams
Director
Financial Markets and Community Investments
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Ms. Williams:

Thank you for providing us with the opportunity to respond to the draft report prepared by the Government Accountability Office entitled *Regulation SHO: Recent Actions Appear to Have Immediately Reduced Failures to Deliver but More Industry Guidance is Needed*, dated May 2009 ("Report"). As part of its mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation, the Securities and Exchange Commission ("Commission") has been focused on improving market confidence and reducing the potential for manipulative short selling by reducing fails to deliver ("FTDs") through focused and proactive measures, including adoption of Regulation SHO. As the Report notes, our actions have successfully reduced FTDs across the market in all securities.

I appreciate the GAO's recommendation to provide guidance for prime brokerage arrangements in light of Regulation SHO. As the Report observes, Commission staff has been working with industry to develop guidance on the information flow between prime broker-dealers and executing broker-dealers regarding customer representations pertaining to a sale of securities. In connection with consideration of further action on Rule 204T, I anticipate that the Commission will consider the need to clarify the communications between prime broker-dealers and executing broker-dealers that would facilitate Regulation SHO compliance.

The GAO also recommends that the Commission develop a process for addressing operational issues that arise from implementing Commission regulations, such as interim final temporary rules. I note that the staff regularly provides guidance to the industry. For instance, the staff published (on the Commission Internet Web site) numerous responses to frequently asked questions ("FAQ") concerning Regulation SHO beginning in 2005, as well as a number of interpretations of the September 2008 emergency orders.

During a routine rulemaking, pursuant to the Administrative Procedure Act ("APA"), the Commission proposes a rule, solicits comments, which often reflect the industry's operational concerns, and addresses the comments in connection with adoption of a final rule. Unlike routine rulemaking, interim final temporary rules are unique and are generally adopted in exigent

Ms. Orice Williams
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circumstances such as the market downturn that occurred in the fall of 2008. Following adoption of an interim final temporary rule, the Commission solicits comment, but the rule is in effect during the comment period.

During the comment process for interim final temporary Rule 204T, the industry raised a number of operational issues. The Commission and staff are in the process of evaluating these comments with a view towards considering further action in this area over the next several months, prior to expiration of the interim final temporary rule. The staff has kept the industry apprised of this approach.

We are committed to engaging in a deliberative process to develop meaningful regulation of short selling, while also providing interpretive guidance to the industry to facilitate implementation, as appropriate. As noted in the Report, in some instances, Commission staff may be unable to provide requested guidance sought by market participants – for example, in cases in which requested relief may lead to the use of strategies that would circumvent rules, or undermine the purposes for such rules. Going forward, we will evaluate whether there are additional steps that we can take, consistent with the APA, to address implementation issues raised by industry.

The Commission is committed to maintaining fair, orderly, and efficient markets. I greatly appreciate the GAO's review and recommendations provided with an eye towards helping us to achieve these goals. If you have any questions, please feel free to contact me at (202) 551-2100, or contact the Deputy Director for the Division of Trading and Markets, James Brigagliano, at (202) 551-5700.[1]

Sincerely,

Mary L. Schapiro

Mary L. Schapiro
Chairman

[1] Commission staff is separately providing technical comments on the Report to GAO staff.

Appendix V: GAO Contact and Staff Acknowledgments

GAO Contact

Orice M. Williams, (202) 512-8678 or williamso@gao.gov

Staff Acknowledgments

In addition to the contact named above, Karen Tremba (Assistant Director), Lawrance Evans, Stefanie Jonkman, Matthew Keeler, Marc Molino, Carl Ramirez, Barbara Roesmann, Jeremy Schwartz, and Paul Thompson made key contributions to this report.

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