

particular, we believe that they will protect buyers of securities by substantially curtailing naked short selling. We request comment on the extent to which the proposed rules will achieve these objectives.

Q. What harms result from naked short selling? Conversely, what benefits accrue from naked short selling?

Q. Are there negative tax consequences associated with naked short selling, in terms of dividends paid or otherwise?

Q. What is the appropriate manner by which short sellers can comply with the requirement to have "reasonable grounds" to believe that securities sold short could be borrowed? Should short sellers be permitted to rely on blanket assurances that stock is available for borrowing, *i.e.*, "hard to borrow" or "easy to borrow" lists? Is the equity lending market transparent enough to allow an efficient means of creating these lists?

Q. Should short sales effected by a market maker in connection with bona fide market making be excepted from the proposed "locate" requirements? Should the exception be tied to certain qualifications or conditions? If so, what should these qualifications or conditions be?

Q. Should the proposed additional delivery requirements be limited to securities in which there are significant failures to deliver? If so, is the proposed threshold an accurate indication of securities with excessive fails to deliver? Should it be higher or lower? Should additional criteria be used?

Q. Are the proposed consequences for failing to deliver securities appropriate and effective measures to address the abuses in naked short selling? If not, why not? What other measures would be effective? Should broker-dealers buying on behalf of customers be obligated to effect a buy-in for aged fails?

Q. Is the restriction preventing a broker-dealer, for a period of 90 calendar days, from executing short sales in the particular security for his own account or the account of the person for whose account the failure to deliver occurred without having pre-borrowed the securities an appropriate and effective measure to address the abuses in naked short selling? Should this restriction apply to all short sales by the broker-dealer in this particular security? Should the restriction also apply to all further short sales by the person for whose account the failure to deliver occurred, effected by any broker-dealer?

Q. Should short sales effected by a market maker in connection with bona-fide market making be exempted from the proposed delivery requirements targeted at securities in which there are significant failures to deliver? If so, what reasons support such an exemption, and how should bona-fide market making be identified?

Q. Under what circumstances might a market maker need to maintain a fail to deliver on a short sale longer than two days past settlement date in the course of bona fide market making? Is two days the appropriate time period to use?

Q. Are there any circumstances in which a party not engaging in bona-fide market

making might need to maintain a fail to deliver on a short sale longer than two days past settlement? If so, can such positions be identified? Should they be excepted from the proposed borrow and delivery requirements, and if so, why, and for how long?

2. Long Sales

Current Rule 10a-2 covers delivery requirements applicable to long sales of securities registered or admitted to unlisted trading privileges on a national securities exchange. We are proposing to adopt subparagraph (a) of Rule 203 in proposed Regulation SHO, which would replace and modify Rule 10a-2 to make it consistent with the new delivery requirements in the proposed short sale rule.

Generally, Rule 10a-2 provides that if a broker-dealer knows or should know that a sale is marked long, the broker-dealer must make delivery when due and cannot lend securities to do so. If the broker-dealer does not have the securities, it must make delivery with securities purchased for cash, *i.e.*, effect a "buy in," unless it knows that the seller either is in the process of forwarding the securities to the broker-dealer or will do so as soon as possible without undue inconvenience or expense. Broker-dealers are excused from the buy-in requirement in two cases. In sales between broker-dealers, loans are permitted in lieu of a buy-in. The rule also allows a broker-dealer to fail to deliver, or to borrow securities in lieu of buying-in, if, despite the broker-dealer's efforts to ensure that the sale was long, it was in fact short. This exemption is available only if the exchange or national securities association in whose market the sale was effected finds that the sale resulted from a good-faith mistake, the broker-dealer exercised due diligence, and either that requiring a buy-in would result in undue hardship or that the sale had been effected at a permissible price.

Subparagraph (a) of Rule 203 of proposed Regulation SHO preserves the substance of current Rule 10a-2 regarding delivery of securities sold pursuant to orders marked "long." Only two substantive changes have been made. First, Regulation SHO would extend the delivery requirements of Rule 10a-2 to all securities, including those traded over-the-counter. As with our proposal to apply borrow and delivery requirements for short sales in all equity securities, we believe it is equally important to apply long delivery requirements to securities with lower market capitalization that may be more susceptible to abuse.

Second, proposed Regulation SHO would provide that a loan or failure to

deliver is permitted if the seller has informed the broker-dealer that the seller owns the security and will deliver it to the broker-dealer prior to settlement of the transaction, but fails to do so. The proposed modification tracks the proposed amendments to the order marking requirements, which would permit an order to be marked long if the seller owns the securities and the seller's broker-dealer will have physical possession or control of the security prior to settlement.⁵⁸ The proposed rule would permit a broker-dealer to fail to deliver, or to deliver borrowed securities, if an exchange or national securities association found that the broker-dealer used due diligence in obtaining the seller's confirmation that the security would be in the broker-dealer's possession prior to settlement, and that either compelling a buy-in would result in undue hardship, or that the mistake was made by the seller's broker-dealer and the sale was at a permissible price under Proposed Rule 201(b) of Regulation SHO.⁵⁹ We believe that this change would facilitate the process of clearance and settlement, while still achieving the goals of short sale regulation.

Q. Are the delivery requirements in proposed Rule 203(a) appropriate?

III. Current Market Structure and the Tick Test

The tick test was part of short sale regulation implemented in 1938. The tick test has provided the markets with a generally effective means of regulating short sales for more than 60 years. Nonetheless, arguments have been made to allow greater flexibility in short selling. Indeed, substantial economic arguments have been made that short selling should be deregulated, at least in the case of the tick test.⁶⁰ Some

⁵⁸ See, *infra* part IX for a further discussion of the proposed order marking requirements.

⁵⁹ This exception shall not apply where a broker-dealer knows or has reason to know that an order is incorrectly marked long. Knowledge may be inferred where a broker-dealer repeatedly accepts orders marked long from the same customer that requires borrowed shares for delivery or results in a "fail to deliver" on several occasions.

⁶⁰ See, *e.g.*, Albert, Smaby, and Robison, 1997, *Short Selling and Trading Abuses on Nasdaq*, Financial Services Review, 6(1), 27-39; Alexander and Peterson, 1999, *Short Selling and the New York Stock Exchange and the Effects of the Uptick Rule*, Journal of Financial Intermediation, 8, 90-116; Alexander and Peterson, 2002, *Implications of a Reduction in Tick Size on Short-Sale Order Execution*, Journal of Financial Intermediation, 11, 37-60; Angel, 1997, *Short Selling on the NYSE*, working paper, Georgetown University; Jones, 2002, *Shorting Restrictions, Liquidity, and Returns*, working paper, Columbia University; Lamont, Owen A., 2003, *Go Down Fighting: Short Sellers vs. Firms*, working paper, University of Chicago and NBER.