NASAA Conference on Naked Short Selling

November 30, 2005

Transcript of Audio

Patty: Good afternoon. I'm Patty Struck with Wisconsin Securities Administrator and President of the North American Securities Administrators Association, the oldest international organization devoted to investor protection. Our members include securities regulators in the United States, Canada and Mexico. On behalf of NASAA, I welcome you to our continuing series of NASAA Listens Forums. I also welcome those of you listening to the live webcast of today's forum. Through this forum we hope to provide a venue for fair and open dialogue on vital issues facing investors, regulators and industry.

We decided to focus this forum on naked short selling activity and its effect on the market. As regulators, we are deeply concerned about the detrimental impact of abusive short selling on the stock of small businesses, the entrepreneurial engines that drive our nation's economy and on investors in our states. Before I turn the program over to our moderator, Connecticut Securities Director, Ralph Lambiase, I want to thank Ralph, along with Illinois Securities Director, Tanya Solov, former Vermont Securities Deputy Commissioner Tanya Durkee, along with Bill Reilly, Chief of Florida's Bureau of Securities Regulation and NASAA's General Counsel, Rex Staples for their diligent work in bringing together this distinguished group of panelists. Background information on each of the panelists is included in your packets and is on the NASAA website for those of you listening in.

I also want to thank the Securities and Exchange Commission, the New York Stock Exchange and the NASD for participating in what I know will be a lively discussion that will bring to light additional ways to prevent abusive short selling practices. I know you'll have a lot of questions, so there are cards available. Please pass them to a NASAA representative as your questions arise. Thank you.

Ralph: Okay, well, my name is Ralph Lambiase. I'm the Securities Director for the State of Connecticut. First let me thank Patty Struck and the Board of Directors for supporting the NASAA Listens Forums and I want to again reiterate the…

(background talk)

Ralph: And also let me reiterate the thanks and appreciation to Tanya Solov, the _____, Rick Staples the General Counsel, Tanya Durkee, the former Vermont Commissioner. You have no idea on the amount of time and help that they've been able to make this thing a success. I hope it will be. And let me also thank our panelists. They are devoting their time to come here today to discuss the issues. And that's very important because without a discussion in an open forum, we will not be able to see any changes that may need to be implemented and to understand how all the system may be working as we stand today. So to all of you, I'm not going to get a chance later, but our appreciation from our Association and from all those listening for you coming here today to address the issues. Let me -- I'm not going to read the bios on all of our folk, but let me just give a highlight, just starting down with the list I have:

Professor Jim Angel, Associate Professor Finance at Georgetown University. One of the particularly interesting notes about Professor Jim, I'll call him Professor Jim -- how about I call you that -- was that last year he was asked to design the Shanghai Stock Exchange Stock Lending Markets. So that's quite an accomplishment.

Jim Brigagliano, from the SEC is an Assistant Director for Market Regulation. Jim, welcome (*referred to as Jamie in some later dialog – ed. note*).

Peter Chepucavage, Peter was a former member of the SEC drafting the Drafting Reg SHO and Peter is also now the General Counsel of Plexus Consulting Group in Washington, DC. Peter, and I think you bring what 30 years of experience to the table, what is it? Ah, you're still learning, don't worry. Take care of it.

Professor John Finnerty, Professor Fordham University. Professor Finnerty has written several articles, published before international associations on financial associations, particularly one of the ones which I happened to read was on death spiral and Anthony(?) and I think that was a tremendous piece of work. Jim's papers, those were also available through the SEC's website. That's how actually we found a lot of the folks. And so thank you for the SEC for having a lot of the papers on their website.

Cam Phunghouser(?), Cam's with the NASD. He's been in for the health in market regulation how many years now, Cam? 21 years. Starting at 14, make that clear for the record.

Anand Ramtahal, Vice President, Market Member of Firm Regulation, New York Stock Exchange.

Dr. Robert Shapiro, Dr. Shapiro was Undersecretary of Commerce and was actually the Principal Economic Advisor if I'm not mistaken to President Clinton during the 1991 and '92 campaigns. So, Dr. Shapiro, we welcome you and I've also read some of your work.

Dr. Susanne Trimbath. Dr. Trimbath has at least ten years' experience with DTC Stock Lending Clearing Operations and also was involved in establishing the clearing operations, is it Susan, for the Russian markets, went over to Russia and set up the clearing operations over in Russia.

So with that distinguished list of candidates, I, of course, am just Ralph Lambiase, Director of Securities. So let's start with a few questions. Let me do a little basic first. There's four points I want to cover. One, what I wanted to do is just say what a short sale is and make sure we were all on the same page. Is that fair? Okay, short sale is the sale of a stock which you don't own or that you will borrow for the delivery. Short sellers believe, generally, that the stock of a price will decline and they're seeking to hedge against the potential decline or any price volatility of portfolios they have. That is short selling. With that there's no issues regarding short selling. And I want to distinguish the issue of short selling with naked short selling. Naked short selling is the sale of a security that the seller does not borrow or arrange to borrow the securities in time to make the delivery. Delivery would be in T+3. We understand that's what we're looking at right now are the naked short selling. So that's where we want to focus our energy. If the seller fails to deliver within the three days and hence you get what's commonly referred to a Failed to Deliver or FTD, the acronym used for that.

Q: Excuse me, Ralph, when you talk about naked short selling, you're talking about kind of a deliberate intent not to borrow and not to deliver as opposed to the stock's located but the delivery is delayed for one reason or another where it's not deliberate?

Ralph: Actually, James, it's actually going to be both because in some respects there are Fails to Deliver which there are particular reasons for. What we would like to also focus on is those who willfully design their transactions to avoid the delivery in the first place and then the manipulative consequences, which they may be intending to try to derive.

Q: Where the intent is to drive, use naked short selling to drive down the price of the stock.

Ralph: Yes.

Q: Okay.

Ralph: But I think you've asked a very valid point, that short selling could occur and you could get fails very legitimately. And then you can also find _____ that could be a failure to deliver for whatever other reason. But right now, I think, what we would like to focus on is the naked short selling with an intent to drive the market down. I think that's really what we want to focus on.

Q: [Inaudible]

Ralph: Okay. All right, now let me bring up the -- and James you can correct me on this because this is your particular area, '34 Act. '34 Act 15c3-3 talks of -- it's called the Customer Protection Rule. And that says physical -- this is what Congress would require, that a broker or a dealer shall promptly obtain and shall thereafter maintain the physical possession or control of all fully paid securities and excess margin securities caused by a broker/dealer for the account of its customers. So that is one rule that applies to this area. And let me bring up the second one and then Jamie if you want to make a comment, please do. 17A, it says Congress finds that the prompt and accurate clearance and settlements of securities transactions, including the transfer of records of ownership and the safeguarding of securities and funds related thereto are necessary for the protection of investors and persons facilitating transactions by and on behalf of investors. So that would put it in the context that there's a federal mandate that securities settlements be made. Jamie, is that…?

Jamie (SEC): Yeah, well I think that 17A called upon the Commission to adopt a uniform clearance and settlement rules to facilitate a sound clearance and settlement process. The Commission did a number of rules under the notice and comment process and we have what we have. The Cong 17a doesn't require that it's a violation of a rule for a stock that takes more than three days to settle -- it doesn't require that that violate a rule.

Ralph: No. And that's _____ distinguish.

Jamie: And that gets into the innocent fails. I think the Commission determined that if you entirely precluded innocent fails and made it a violation, every time a stock took more than three days, even for innocent reasons, that that would -- could severely hamper liquidity where there wasn't really a problem. I think it's important to get a little context here and understand that while there may be cases of abusive naked short selling and the Commission will pursue those cases vigorously when it has evidence of violations, that 99 percent of the trades by dollar value settle on time without incident. So we may be talking -- we're talking about a real problem here but it isn't most of the clear -- it isn't most of the stock trading.

Ralph: Okay.

Jamie: And that context, I think, is important. And I think it's been lost.

Ralph: And no, actually, since we just started, we will get into that a little further. But what I was trying to do was say that it does appear that it was congressional intent that there be prompt and accurate clearance of settlements of securities transactions.

Jamie: And I think generally that goal has been achieved.

Ralph: I didn't say it wasn't. All I'm basically saying is that is the intent of Congress. What we'll do from this point on is go forward with, I think, some other basic questions and then we can see how things develop.

Q: Can I ask you one thing, what Jamie said. There is an old case out there called Nastalen(?) versus Merrill Lynch. It goes all the way back to 1972, but I think it's still current law. And the discussion about prompt settlement would probably surprise everyone in this room. So if you have the occasion, 469F 2nd 1166(?).

Ralph: Okay, make sure you speak -- I'll caution the panelists to make sure they're speaking into the microphone.

Female: Pull it closer.

Ralph: Pull it closer as you speak, okay?

Q: Okay.

Ralph: And if for some reason we're not making ourselves relatively clear, please let me know. Okay. Actually, Jim, let me, Professor Angel.

Jim: Professor, Jim, either one.

Ralph: Let me ask you just a fundamental question. Should there be an approved list of equity securities that may be allowed to be shorted as opposed to what we have today.

Jim: Yes. I would say that every equity security should be shortable as long as the short sellers obey the rules and are able to deliver their shares on settlement.

Ralph: Okay, so you don't necessarily think that we need to have an approved list of which securities should be eligible for short selling?

Jim: No, I think we should leave that up to investors themselves to decide their own trading strategies. As long as the short sellers obey the rules, as long as they can deliver the shares on settlement date, they should be allowed to short.

Ralph: Okay. Any other comments or observations? All right. The reason I brought that up is I understand Australia uses an approved list. So what I was wondering was whether or not the United States really should wind up with an approved list, which would set some minimum standards for the trading. But if it's the consensus of the panel not, that's fine. Let's just move to another particular question I have. If I were to purchase security, when is the payment due? Anybody? Simply speaking, I buy a stock, when is my payment due?

Anand: I'll take that. Ralph, it's due on settlement date, which is three days after the trade date.

Ralph: Three days after the trade date. So if I don't make that payment, what's the consequence for me not making that payment?

Anand: The broker can apply for an extension for you to make payment. It's called a Reg T Extension. Extensions are filed with the broker's DEA. So if it's a New York Stock Exchange member, the Reg T Extensions are filed with us.

Ralph: Okay, they can also what they call bust the trade.

Anand: If a broker chooses to, they could.

Ralph: Okay, so you can bust the trade after three days if I haven't made settlement.

Anand: Or file for an extension.

Ralph: Right, one of the two options. Okay. So we just want you to understand the general understanding of the folks on how the industry is operating. And we're going to go further, believe me. But so when does the -- when are the funds available to the seller, then? Are the funds available to the seller at the third day? Or are they immediately available?

Anand: That is correct. No, they're available on settlement date.

Ralph: When does the broker/dealer, the selling broker/dealer receive the commissions?

Anand: It may vary by brokers, but I would assume that it would also be on settlement date.

Ralph: Settlement date, right, so that if shares are not delivered everybody's still paid, basically.

Anand: The commissions, yes.

Ralph: Yes, okay. I'm just trying to check. I want to make sure I understand the money flow also.

Shapiro: I think, Ralph, you were talking earlier about purchases. Let's talk about the sales because you're not paying for the shares in question. That is, if the person sells the stock when does he or she get the cash. And on a short sale, the broker's going to hold that cash to collateralize. They use that collateral as the borrowing and if you do a naked short you don't get the cash unless the broker lets you have it. And I think one of the problems is that the broker in fact may be releasing some of that cash to the naked short sellers.

Ralph: Right.

Shapiro: The theory _____ delivery even though there's no delivery. There should be. It should be against delivery but it isn't always against delivery.

Ralph: Right, so if you naked short sell then it is very possible that there are funds being sent to the person who is naked shorting. They are getting access to the funds; meanwhile, they still haven't made delivery.

Shapiro: That is possible.

Ralph: That's Professor Shapiro, Dr. Shapiro.

Shapiro: They would get access to the funds as the price of the stock falls. So the collateral is -- the brokerage house will hold 110 percent of the funds equal to 110 percent of the value of the stock. So as the value of the stock falls, funds are being released to the short seller, even if he…

Ralph: Hasn't had delivery.

Shapiro: Even if he hasn't delivered. And this is a particular problem if the -- in the event that large-scale naked short selling is being used to drive down the price of a stock because then in effect the naked short selling becomes a self-fulfilling prophecy and the naked short seller pulls the funds out as the stock falls.

Ralph: And then it's _____ -- Dr. Shapiro or anyone else, isn't it possible to say that if you're going to naked short sell, that there's no payments being given to the seller until delivery's made? I mean is that something that could be done?

Jamie (SEC): In fact this was a proposal of the NASD as part of the original draft of Regulation SHO _____.

Ralph: Jim, let Dr. Shapiro finish.

Shapiro: And perhaps supported by the NASD _____. I stand corrected. Unfortunately, that provision was pulled out between the original draft…

Ralph: That the payment be withheld?

Shapiro: The SHO and the final version of it.

Ralph: Okay because in some ways it seems that you're benefiting the seller by having him not delivered but still giving them access to funds, which means that if I want to continue to do some other activity I could do it because I am getting some funds. Jamie, I didn't mean to cut you off, but go ahead now, please.

Jamie: Dr. Shapiro made that very technical correction that I suppose Cam would have made as well. And I wanted to note that to the extent I express views here today, they're my own and not those of the Commission or other staff. And it's worth hearing that proposal because when the Commission next revisits SHO Regulation, I'd be happy to address that later, that's the kind of thing, that's the kind of comment that'd be useful to hear.

Ralph: Yeah and actually that is, again, the reason for the forum, is to present ideas and hopefully that those that are good will be evaluated, studied and acted on and those that fail or go fall to the side, fall to the side. But we do appreciate the candidness and the willingness to listen. That's actually why it's called "NASAA Listens" - we're not making proposals.

Anand: But Ralph, just a quick comment. We can't lose sight of the fact that a short sale is a margin transaction and the customer is required to put up margin to affect the short sale, 150 percent margin requirement, in other words, the market value plus 50 percent. It's the Regulation T requirement which is just like a purchase, 50 percent of the cost of the securities. And I'm not sure if delivery is not made on settlement date that a customer has access to funds on a short sale. In fact, they do not.

Ralph: Okay, now, that -- for those -- there's many listening in the webcast, so Anand, I'm going to make sure that's Anand talking.

Anand: So bottom line is we have to keep abreast of the equity that's sitting in the customer's account so that they might be able to withdraw some of the funds, but if a transaction does not settle, a customer does not have access to the proceeds of a short sale.

Suzanne: And Anand, what about marked to market? As the price of the shares goes down, does the margin requirement also go down with it and then cash is released back to the seller?

Anand: ….That's correct.

Male: That was my entire point.

Ralph: Okay, I think the point that you're making was what I was going to ask anyway, if I can get this thing functioning well, it's marked to market so that monies are released as the stock declines additional monies are then provided to seller so therefore they are not locked up at the 150 percent…

Anand: That's correct.

Ralph: Constantly marked to market. By doing that you are in fact releasing the funds to the seller. Okay, I just wanted to make sure I'm clear on that because part of this…

Male: I'm still not clear on that.

Ralph: Ah, sir, okay, may I ask that questions really need to be directed, written and then directed into the center of the room. The reason we need to do that is because I have a substantial number of questions I'm going to ask. So I would ask that we try as best we can to refrain but from that. I thought we fully aired that, that if you marked to market then monies are in fact being released. Okay, so it's not at the 150 percent. So I have a -- believe me when I say I have a whole series of questions and allow me the opportunity to go through them. Those which aren't answered, we will still evaluate at the end of the session and try to get more answers on or clearer answers.

I have one here. It says the SEC's website had a particular language on it saying that the grandfathering provisions of Regulation SHO were adopted because the Commission was concerned about creating the volatility where there were large, preexisting open positions. And this is on the website, so I'm not holding anybody accountable on this one right now. The fail statistics of individuals and firms and customers(?) in proprietary information and may reflect a firm's trading strategy. The release of this information could be used to engage in the unlawful upward manipulation of the price or securities in order to squeeze the firms improperly. What I was going to say was there does somewhat appear to be a concern about upward price manipulation and should really also be looking at downward price manipulation. And what I was going to do was ask Peter on this one if you would mind taking an open and give me your perspective on that one.

Peter: Well, I know the language and I think it was a policy decision to arrive at a compromise that wouldn't "upset the market". You don't know when a stock is going to go on a threshold list, so to penalize someone who wasn't thinking of the threshold list would arguably be unfair. Now, if it's not working that well, I leave it to Jamie and future rule making.

Ralph: Perhaps Finnerty, you have a comment?

Finnerty: Yes, I don't know why upward manipulation is any more worrisome than downward manipulation. In both cases you're driving the market price away from the equilibrium value. And I think that we should treat them symmetrically. And one of the problems we now have is we don't have transparency. You don't have proper disclosure of naked short selling, fails to deliver and if we did I think that would help an awful lot in trying to solve the problem.

Ralph: Okay, I, in the reading I've done on it, this grandfathering seems to be a bigger issue for I guess perhaps folks like myself who wonder why do you grandfather the prior fails when there was an obligation for people to make delivery on those fails in the first place?

Peter: Can I add to that to address that specific question?

Ralph: Okay and then allow me to follow up with another one.

Peter: Okay, thanks.

Ralph: And perhaps Jim I think wants to make maybe an observation. So right now, Peter, why don't you take it?

Peter: I think there's a misunderstanding about what I refer to as the forward effects of Reg SHO and the look back effects. To say it more clearly, if those grandfathered fails were due to an illegitimate locate or no locate at all, then the wrath of the SRO should be down upon those people. I think from what I've read in some of the commentary suggests that there was an amnesty, an amnesty for those grandfathered fails. That was never the intent of the rule. You were always going to have two aspects of the rule, one going forward and one increasing the enforcement of the locate requirement in the past. So I don't think it's fair to say that somehow those people are grandfathered without any penalty if they inappropriately naked shorted.

Ralph: I'm going to -- I have some questions in sequence, so I'm going to put one out because I need to follow up on that. I really did have difficulty understanding it myself, which given my background I should be able to grasp relatively most issues in the market. But Professor Jim, do you have any comments on this one yet or do you want me to…?

Jim: I'll hold off for the moment.

Ralph: Okay, let me.

Cam: Ralph, I just think there has been a lot of concern or some concern expressed about the grandfather. I think that Peter and the website disclosure addressed the Commission's stated purposes for why it adopted the grandfather. And I wanted to make two points. One is that the grandfather doesn't prevent the Commission from enforcing these anti-manipulation rules, should it have evidence that there has been a downward manipulation. And second, among the thing, the activities that we're currently engaged in are an extensive round of exams of 45 broker/dealers on compliance with SHO in all its aspects. And we have also asked the SROs to look at certain securities that have been on the threshold list for an extended period. Now, we will analyze the results of those exams and that inquiry and a couple results could follow. Obviously, if people have been complying with the rule, then there are deficiency processes and enforcement inquiries and actions that could follow. And from the regulatory side, if we determine that the grandfather provision or any other provision of SHO is not doing what it was intended to do or is having unintended consequences, we will recommend that the Commission consider changes to the rule. And we're going to do that based on the empirical evidence that we obtain from exams that are comprehensive and extensive.

Ralph: Okay. Cam, that's a terrific point to make.

Male: Let me use your microphone.

Anand: That's a real good point that I'd like to reiterate. One thing, let me make a comment. We have a rule that just has been posted for comment New 3210, NASD 3210, which expands Reg SHO to the non-filing OTC companies. And if you look closely at the end of it, the SEC has asked for comment, formal comment on that proposal and while it's a narrow rule which really extends to the non-filing OTC companies, the Reg SHO provisions, it's a really good opportunity if you have comments to voice them there so they get embodied within that rule proposal. And just so I can maybe comment a little bit about some of the things we've been doing so that there's not this fear mongering that there's this rampant naked shorting that's gone unregulated. I think if you look closely at our enforcement actions and our disciplinary actions, you're going to see that we approach it two ways at NASD. One is we are continually looking for what I'll call parking violations, parking ticket violations, not traditional stock parking. And you're going to see that we've done about close to three quarters of a million dollars in fines for mere compliance violations related to short selling. That means marking the tickets wrong, not documenting properly. That's one important aspect, sort of like the Rudy Giuliani approach to crime. I mean if you're jumping the turnstiles, it's probably other bad things could be happening. I encourage you to look, if you don't know about these cases, for over ten years we've taken a very aggressive posture with fraudulent downward manipulators or people who are using short selling to perpetrate a fraud. You can look at any of the -- DiPiero(?) and some of these other cases and you'll see that we agree that there are opportunities to improve but there have been a number of disciplinary actions on both the compliance side and the fraud side.

Ralph: Thank you. Hold on, excuse me. Let me take the prerogative of saying thank you. One statistic I had heard was there was less than cases that were brought on short selling cases that were done in the last ten years. So I'm not sure, perhaps there's a rash that I missed, but I'm not sure over this period of time that there's been a significant number of enforcement cases that were brought. Notwithstanding that, I have a couple of questions. John, if you have…

Finnerty: I wanted to add on that particular point that we keep hearing the regulators saying well naked short is not really a serious problem, fails to deliver not a serious problem. Show us the data. Let's take those transactions that were grandfathered and let's find out what the duration of those fails is. How many of those grandfathered fails are still sitting on the books and if we take those fails and we count them for the threshold list test, how many more stocks would be on the threshold list? And if that data were available, I think we could answer the question of what's the effect of the grandfather _____.

Ralph: Well and that's a very valid point because you might have been looking over my -- were you looking over my shoulder at my question?

Finnerty: Ralph, I wouldn't.

Ralph: This question -- Jamie, this question is for you. Jamie, if I may, this question is…

Jamie (SEC): I don't know what it is yet.

Ralph: Sir?

Jamie: I don't know what it is yet, so ask away.

Ralph: Well, you got to give me a little credit to see if I can get a little bit of action. What was the dollar amount of fails that were grandfathered in during Reg SHO's initial start?

Jamie: Ralph, I can obtain the dollar amount and I'd be happy to do that. It was -- we think it was four percent of the number of stocks or on the threshold list or would have been on the threshold list at the beginning. So I don't have the dollar value, but as a percentage of securities it's four percent of the stocks trading and that's been cut to below two percent.

Ralph: Okay, now of the four percent, how many shares were -- how many companies were trading because I'm not sure how you measure that number?

Jamie: Well, four percent of the stocks that are listed for trading.

Ralph: On the New York Stock Exchange, NASDAQ, all the BP(?) markets?

Jamie: Yes, yes, all the markets.

Ralph: So then that would have to be…

Jamie: Except the pink sheets, which were not covered by SHO and which Cam…

Ralph: I could accept that, right. I could accept that. But remember in my days the New York had listed roughly 20-something hundred stocks. How many stocks trading on NASDAQ approximately?

Jamie: The total on all the listed exchanges.

Ralph: I love this, yes.

Jamie: Is between 6,000 and 7,000.

Ralph: I was going to go to ten. But I, please I'll take a 7,000 number. So four percent of the 7,000 shares had fails on them. Is that about accurate?

Jamie: That's -- I mean _____.

Shapiro: Well, four percent were threshold, would have been threshold stocks.

Ralph: Well, but the threshold stocks had fails, which is why.

Shapiro: Yes, yes, at the requisite level.

Ralph: I was just cutting to the chase _____. This is Dr. Shapiro speaking. Please.

Shapiro: The problem is - and Dr. Finnerty alluded to this - is that knowing that a stock is on the threshold list doesn't tell us nearly enough. That is it tells us that the fails are equal to at least 10,000 shares or a half a percent. But in fact it could be equal to a half a percent, it could be equal to ten percent, it could be equal to -- in a case of terrible manipulation -- much higher than that. And again, this is a question of data. The data are there. The DTC know the number of fails for every stock out there listed and unlisted. They get a daily report. They not only will not release that to the public, they won't even release it to the companies themselves who may have millions and millions of extended fails to deliver out against them.

(Applause)

Ralph: Okay, you know what? We're going to… Hold on for a minute folks. We're going to follow up on that Dr. Shapiro. And I had a couple of questions because I looked at the Reg SHO list and I saw some things which kind of stuck out to me. So what I figured I would do is I'd take a few of the examples that I saw and then ask the questions and maybe that could put things in a proper context. But Anand, I will always refer to you. He had to correct me a hundred times when I met him I think, so.

Anand: Just a couple of quick comments. One, the grandfathered fails are included in the determination of threshold securities. It's all fails at the clearing organization. Grandfathered fails are included. The other thing, in as much as there is an exception in the regulation that does not require brokers to close out failed to delivers that are grandfathered, during the course of our examinations, and we've done a bunch of them, we make it a point of instructing our members that you do have an obligation and it's a good business practice to close out, to take action to close out all fails, not just fails which are not grandfathered.

Ralph: Yes, no and that is a very good point that you made, Anand. And I think it may -- I don't know if you need to reiterate it, but the grandfather does include the prior fails. That's basically what you're saying.

Anand: That's correct.

Ralph: And I think that's a very fair point. We need to keep that in mind. Now, somebody needs to help me because I try to look at the Reg SHO list. I've gotten to the point where if I can avoid things I do. But I did decide, "All right, let me look at the Reg SHO list and see if I could read it." Okay? And so that's all I did, look up the Reg SHO list, November 23rd. And I'm not going to talk about a company because I don't think companies -- companies are not the issue to us. I need to make that clear. Companies are not the issue. The process of the fails is the issue, not companies on how they got on the list and what have you. Everybody stumbles and so I'm not going to discuss, none of us will, merits of companies, nor will we actually discuss any particular company. So given that, let me just say that I looked at the 11/23 Reg SHO list. And this is as close to the line as I could get is I noticed there were like five of them that kind of just perked up that brought up different issues for me. So I'd appreciate somebody telling me how to read this Reg SHO list. I looked at it and of the five companies, one of them was on the list for the entire 222 days. Okay? Another one was one for 214 of the 222 days that Reg SHO has been in existence. Okay? So Reg SHO's been out there, for the audience, 222 days. One company was on for the entire 222 days, another company was on it for 214 and two others were on it for 190 days. And I was going to ask how is that and shouldn't Reg SHO have eliminated or helped eliminate those lengths of time that companies were on? And this is a three-part question, so I've got two more. So, does anybody in the -- anybody on the panel could help me?

Male: Which market is it in? Which market?

Ralph: My recollection was they might have been NASDAQ's.

Male: It's NASDAQ's question to answer.

Ralph: Well, you know, hang on. No, okay. If they choose to. However, I'm not trying to put somebody on the spot. I'm simply trying to ask the fundamental question how could a stock be on Reg SHO list for the entire 222 days? All right, hang on. No comments from the audience. Give you five demerits later for that question.

Male: They're allowed to give us the answers, right?

Ralph: Does anybody want to comment on that on the panel?

Jamie: Well, Ralph, excuse me. I mean there's a couple of reasons that we have already alluded to that there could be -- it could be grandfathered fails. There can be new fails. There can be fails from a long fail, which is one thing I wanted to mention in response to Dr. Shapiro's concerns. And by the way, we are considering, at least at the staff level, the issue of whether there should be further disclosure of fails information.

Ralph: And we're going to follow that up, because I know that is something you're interested in.

Jamie: And as to other particular reasons why a stock may be on the threshold list for an extended period, as I noted that that is a fundamental focus of exams currently.

Ralph: That's great.

Jamie: And we want information as to why that happens and whether it leads to an enforcement issue or whether it's a regulatory issue that should be fixed with an amendment to the rule. But we would like good information to make that decision.

Ralph: Jamie, I think that part of what we do for a living is to make sure that at least if the issues are raised other regulators, all of us, that is our job to say, "Yeah, we're looking at that. We're concerned". And I think the public needs to understand that things don't change overnight. But clearly if we recognize issues, it is our obligation to try to see what we can do to resolve them. And as long as they're recognized I'm happy. Now… Dr. Trimbath.

Dr. Trimbath: Yeah, I'd just like to clarify the 224 days.

Ralph: 222.

Dr. Trimbath: Those are business days, I assume, settlement days. So that's basically a year, right?

Ralph: Actually yeah, I think it is. I think it is.

Dr. Trimbath: [Inaudible] year, right.

Ralph: It's the number of days - which would be business days.

Dr. Trimbath: It's 200 _____.

Ralph: Given the fact that the only reason I'm able to say that with some degree of confidence is we're getting to the end of the year. It's 222 days, started January, which means it better be business days.

Dr. Trimbath: Right.

Ralph: Or I got problems on my math.

Male: There are 250 to 252 trading days a year.

Ralph: Yeah, so then this would be business days then, to answer the question.

Dr. Trimbath: Basically.

Ralph: Now there's another…

Peter: Ralph, could I -- can I make a point on this that…

Ralph: This is Peter. Peter, go ahead.

Peter: It's okay to say that the regulators are looking at this. But I would think the audience would be thinking, "A year?" And as a regulator, I mean, I don't think we have to be able to answer that today. But I would think that Cam has to go back and talk to some people at NASDAQ and say, "Do we have a good explanation for this?" And maybe they could make that explanation public in an information memo.

Ralph: Well, you know what? And then I'll speak on this one. I think the idea is to get the issues in an open forum and to be fully vetted and to be brought back and to hopefully change the state. Could I go where there's another -- it's another one of the five companies that I looked at? Actually in another instance -- of the one I mentioned that had been on the SHO list for that long, second question. In another instance one company had, I want to say -- and I was just looking at numbers now and I'm not involved with companies. I own one stock. It's less than a couple of thousand dollars. And believe me, I'd give it to you if you want the darn thing, which is why I'm still working today, okay? Okay, in one instance there was one company had about 20 million… I actually had one of my staff look at this issue and if he's listening, thank you Sal and Mark for doing all this for me. But they said there's one company that had about let's say 20 million shares outstanding, just about, ballpark number, outstanding. And they looked at it, they looked at the stock statistics and they go, “Okay, 80 percent of it was shown held by insiders.” Now being relatively smart, you go, “Okay, that’s got to give you about a four million share float if insiders are locking up 80 percent of 20 million.” Right? So that’s four million -- it kind of stands out -- in the float, yet when they looked at the statistics on NASDAQ Trader, whatever it’s referred to, they showed that the total shares shorted was 6.5 million. So the question I have and I don’t know if there’s inaccuracies in the reports, but that would mean if you only have 4 million shares but yet there is 6.5 million shorted, how does that happen? How could you wind up shorting more basically than the shares that are available? Now, Dr. Trimbath, do you want to comment first?

Dr. Trimbath: Yeah, I can take that one. One very simple way, obvious way is that when the short seller sells, someone buys. And when that person buys, because of the clearing and settlement system the way it’s set up, that person takes affirmative delivery of the shares. So even though the short seller sold shares they didn’t have, the buyer bought real shares. Those shares are now available to be loaned out again, to sell again, to short again, whatever you want to do and that then becomes multiplicative. And that’s how you, one way that you can end up with more shares shorted or traded than you actually have authorized by the corporation.

Ralph: You’d actually have to repeat that to me later on because I get a tad lost on that. That’s why I do these panels because I get a chance to ask questions of the professor without getting tagged later for bad grades.

Male (Jamie/Peter?):

I can add a few other things to that. There are all kinds of things that could be going on. Somebody could have made a mistake when they added up the short figures. As Dr. Trimbath has pointed out, once a share is loaned, it can be loaned out again so that you have a multiplicative effect going on. You can have naked short selling where people have not delivered the shares and more than one person thinks they’re the legitimate owner of the shares. So you could have a number of things going on. Or those insiders might have been lending out their shares even though they haven’t been telling anybody.

Ralph: And they hit 150 percent of the float. That’s a lot. I can understand a larger -- now, some of the points you raised I want you to know I’m going to address in a few minutes in further detail. Let me go to the next question on Reg SHO list because these are the same kind of questions the public would have. I mean in other words the same questions I’m asking are the same ones the public asks. And the more they understand it, then I think the better off we all are as regulators so that we give confidence to the public. One other stock I looked at showed on the list for 191 days and 86 percent of the time. In other words, the way they do it is the 191 days is 86 point something percent of 222 days. I finally figured that out. Okay? But then there's another category and it says number of days in a row where the stock was on the threshold list. And it came out zero. Now, I'm not real good, but in math if you're 191 days out of 222, 86 percent of the time, you can't have zero number of consecutive days where it was on the Reg SHO list. Okay? Which led to questions. It led to the fact that assume there's an error, which it's possible or maybe I…whatever. Assume somebody should look at that and come up with an answer someday. If there's an error, how do we go about correcting Reg SHO so that data or corrections made to Reg SHO are reflected for historical purposes. I actually had a question -- I don't know the gentlemen, I don't know him here, but somebody did ask me that question, "If there's an error on Reg SHO and there's a readjustment base to a number, how is that then reflected on the Reg SHO list so that for historical purposes people can understand what was going on?" Is there any thought to that or perhaps thought to be given as we go forward in identifying an error or further correction, subsequent correction?

Jamie: Yeah, Ralph, I'd actually appreciate it if you'd make copies of those questions. I think that Anand, Cam and I would like…

Ralph: Oh no, absolutely. Absolutely. These are not intended…

Jamie: Some of them are quite intricate.

Ralph: Well, no, they are and if people find value in the questions, I'm delighted. I'm not -- like I said, I'm here just to get issues raised. My staff asked me that question. And when I have to hem and haw to them I don't look good. So let me go with a couple of other questions. I've got a whole -- okay, let me go with some more. I think we did this one. Okay, sorry. Hey, lucky, we did that one. There was a paper that I read recently. It was a slow night. No offense to the professor that wrote it. It was a paper called <u>Can Short Sellers Predict Returns: Daily Evidence</u> and it was by Professor Carl Deader(?) from the University of Ohio. And hopefully he understands that I really do appreciate -- he spent a few -- a little time talking to me about his paper and I really enjoyed reading that. He's with the University of Ohio where he's done the paper in conjunction with Mr. Qwan Lee and Professor Ingrid Worma(?). And they found that roughly 25 -- and I hope I don't misstate this from him, he was very gracious to me; 25.14 percent of all fails on the NASDAQ were short sales. That seemed to me a very significant number. And can anybody verify that?

Jim: I can verify that. I've been doing research on similar data.

Ralph: This is Professor Jim. So professor, please, would you please go ahead.

Jim: Yeah, right. And that number also holds true for New York Stock Exchange listed stocks. One of the more interesting things to come out of the Reg SHO data is to highlight the extent to which short selling is used in our markets. And indeed short selling is a vital part of our markets today. It helps keep the derivative markets in line with the spot market. It helps liquidity providers provide liquidity. It helps investors to speculate. You know there are a lot of legitimate uses for short selling and it is definitely a major part of our markets today.

Ralph: And you know what? I just turned my card over and I noticed the Professor Deader(?) made the same, similar observation that he understood that the numbers for the New York Stock Exchange were comparable numbers.

Male: Jim, do you know what percentage of those were market makers?

Jim: Not off the top of my head, but a large fraction.

Ralph: And actually I would certainly leave Professors Deader's name for you guys, so anybody want to follow up on some of that, especially the Commission and SROs, I'd be happy to give you his name. He may not be happy I'll give you his name, but you know.

Finnerty: Can I have one point, Ralph? I think that statistic was for the short positions in the NASDAQ stocks. What's interesting is if you look at the short sales as percentage of total trades across different market centers, what you find is, based on the data I've looked at, that the electronic centers, the ECNs, the electronic exchanges, in those markets the percentage of short sales is much higher, sometimes as high as 40 percent. So that those averages conceal that. In fact, the electronic exchanges have, I think, become the venue of choice for short sellers.

Ralph: Can you do me a favor? You need to repeat that because I think some of that may get lost because the first time I heard that I missed that. The information, I believe you're right, is information of sales made on the NASDAQ market. Now you're saying that…

Finnerty: Those NASDAQ stocks, which of course trade not only in the NASDAQ market itself but they trade on the electronic exchanges. And as those electronic marketplaces have become more and more important in our overall market system, what has happened is those traders that value anonymity -- and let's face it, if you're going to violate the rules or stretch the rules, you're going to do it in a venue that's going to give you as much concealment as possible. The electronic marketplaces are the ones that are attracting that kind of trading. And the statistics to which I'm referring show, for example, that the ArCa over the -- this was a couple of days earlier this year when the NASD staff looked at the trading, they compared ArCa and the other market venues. ArCa, I think was up to 40 percent, two out of five trades were short sales. So overall it's one out of four. But in ArCa it's two out of five. And in the other electronic marketplaces were similar. There's a real distinction between the trading that's going on in the electronic marketplaces and the trading that's going on in the primary markets. And I think one of the effects of Reg SHO is that it's driving the trading, it's shifting the proportion of trading into these electronic markets because of the anonymity that it provides.

Male: Well there's another very good reason why ArCa and INET have had more than their share of short selling. And that is the NASDAQ short sale rules do not apply in those venues, so it is not a level playing field in that the NASDAQ market has rules which sometimes impede short selling. ArCa does not. So it's not a surprise that the short sellers have flocked to ArCa.

Ralph: Okay, let me go back to a more general question before we get too much into detail, more detailed on… One, should we have strict requirements that firms establish a fixed locate of rooms of shares if they're going to short as opposed to having reasonable grounds? That begs the question as to whether or not reasonable grounds is sufficient or whether or not you should wind up with fixed contract or agreements to borrow shares before you actually engage in short selling.

Peter: Yes.

Ralph: Peter? Peter?

Peter: Yes, absolutely.

Ralph: Susanne?

Susanne: I think that pretty much answers that.

Ralph: Hold on, hold on.

Susanne: I think that pretty much answers that. I mean, yes, that would certainly be one way to rectify the situation in cases where you have clearly marked short sells, I mean legitimate short sells. I think on the other hand there needs to be additional rules about closing out final delivery, which is the point that you made when you mentioned the ‘34 Act, the delivery of shares for settlement. That becomes part then of having when you say you have to not just identify the shares but actually bond(?) and make them available. That would allow you then to fulfill the demands of the ‘34 Act, we just actually deliver the shares in time for settlement or closeout.

Ralph: And then at that point I assume you could, if you had to actually locate -- was that actually locate or enter into a contract?

Finnerty: I think if you used the word borrow instead of locate you would endpoint the distinction here.

Ralph: I got you. So if I used the word you have to borrow the shares in advance of doing the short, then I would tend to think that you’d wind up with a three-day settlement on most of these issues, wouldn’t you?

Finnerty: Can I give you an example on that, Ralph?

Ralph: Yes, please do.

Finnerty: You go to a Redskins football game and you go up to the gate to get in and they ask for your ticket. And you say, “Well, I don’t have it with me but I have located it. It’s down with my son in Santa Fe and in three days I’ll be able to deliver it, but I’d like to go into the game.”

Ralph: Okay, because see the stuff that’s going on is…

Finnerty: One more, one more.

Ralph: Something I don’t understand.

Finnerty: You have the New York Stock Exchange examiners come in and they ask you, “You’re short some capital here. You’re short $10 million.” And you say, “I’ve located it. And whenever I need it I can get it for you.”

Ralph: Yeah, I’m not sure they’d be happy with that one over there.

Finnerty: Locate versus borrow.

Ralph: Let me ask you one more question on this and then I won’t be -- just one. Actually, this was a four part, why’d I do that? Okay, well no actually, you’ve answered the question. You go to a three day because I was going to ask what's the purpose for a 13 day settlement, a thirteen day before you buy-in? You wouldn't need that kind of a thing if you went to actually borrowing the shares in advance, you'd be able to settle all your stock in three days, we wouldn't get into these 13 days to settle it, because I always wondered if I've got 13 days to deliver the stock before it's technically able to be bought in, could I have thirteen days to pay for it? I always figured one goes with the other. If you're not going to deliver me, you didn't tell me you didn't deliver it. Why do I have to pay for it? But, I don't know.

Finnerty: The 13 days is premised on the fact that it is a locate requirement and that the efficiency of the settlement system allows for certain legitimate delays. But if you were required to enter into a contract to borrow, you would certainly have quicker settlements. It would be more expensive and the big investment banks would go crazy, but that is an answer. May not be the right answer, but it is an answer.

Male: And the Commission adopted a locate instead of a pre-borrow because it didn't want to impair liquidity in the 98 and 99 percent of stocks where there isn't a problem. Now the locate and how the locate that the Commission adopted is working is also one of the things we're looking at in the exam. And if we see that the locate is not doing what it's supposed to do and making sure that there's a borrowable source of shares and promoting delivery, then the locate will also be subject to reconsideration.

Ralph: Okay. I was going to ask, yeah, Dr. Trimbath to give one point on that and then I'm going to shift to another question.

Dr. Trimbath: Yeah, actually I want to make two points if I can. But the one point, the first point is in answer to what Peter mentioned, the investment banks wouldn't be happy about the borrowing _____....

Annand: Just one quick comment. I mean if you consider the customer is credited with the proceeds of the short sale on settlement date three days later, you wonder if ultimately the customer will not have to pay the cost of financing a stock borrow on trade date, which is three days before. So it's the economics of the transaction and is it fair? So that's a question that we have to think about.

Ralph: Fair to whom?

Anand: The customer. Ultimately if a broker is going to -- a customer has to finance, a broker is going to finance a stock borrow on trade date to cover a short sale that settles three days later when the customer gets the proceeds of the sale. They are financing cost that's involved there.

Ralph: Yeah, but all the stock that they lend out, that's in my margin account -- well, I don't have one, but assuming I had a margin account, all the stock that's loaned out by the broker/dealer, they're making money on it. I don't make anything, do I?

Anand: Well, it's a slightly different issue.

Ralph: No it isn't. You know if they're making money one way they can't get it both ways.

Anand: If you choose to take a loan from a broker to purchase securities on margin, they're extending a loan to you and it's the Customer Protection Rule 43 that allows them to lend out 140 percent of your debit.

Ralph: Anand, you're right, except that what I realize of the business is that there's more and more margin accounts being opened because people want to have a bank account thing hooked to it and they don't allow you to do it through the cash. They want you to do it through margin. So as the percentage of margin accounts has increased dramatically because of whatever reasons, I don't think people recognize that a lot of the stock that they have in those accounts are being loaned out. I don't think that they know they're loaned out and that the broker/dealer is making money interest on those things. So I asked the industry percentage of cash accounts they have versus the percentage of margin accounts they have. And I remember back years ago it was a very small percentage of margin, a large number of cash. Now I think, I don't even know what the statistics are, I don't know what the statistics are, but I think that the bulk of all accounts now are margin accounts for other reasons where you can borrow and do your debt, but in checking accounts and all this other junk.

Anan: Yes.

Dr. Angel: This is Dr. Angel. However, I would like to correct a common misconception in that brokerage firms are prohibited under 15c3-3 from lending out excess margin securities unless they go through a number of burdensome steps. So it's a misconception to think that they can lend shares out of your margin account without notifying you. If you've fully paid for all of those shares, it's basically only the shares you've borrowed against can be loaned out for margin accounts, without notifying you.

Ralph: And there's actually that good of a record-keeping system where they know exactly how many shares were borrowed against? Do you really -- I mean maybe the exam…

Anand: That is a good question.

Ralph: Okay, so maybe the exam systems that are being done will look into that and verify that and give me comfort at the end of the night to know that there is that much accurate, accurate record keeping that not all the stock is being loaned out. Let me ask these questions.

Male: I've got to clarify one thing. I don't think the majority of this stock is coming from margin accounts. I think it's coming from big institutional lenders who have fully paid stock kept away from the broker. I doubt that there's enough margin accounts.

Ralph: Okay, let me ask this question then. I'm not letting you go. I'm just going to ask this question. It says here… I wrote here, actually, are shares which are borrowed to cover shorts identified in any manner? Now that goes back to an old enforcement case I did 25 years ago where somebody loaned the same stock out for collateral for six other reasons, different other people. So ultimately the Commission came in and put rules that said, "Hey, if you're going to loan something out as collateral guys, you've got to identify it so we can track it and make sure it's not used for double collateralization elsewhere." So the question is are shares which are borrowed to cover shorts in any way identified in any manner -- okay, hold on, let me get the second part of it. And what stops a single share from being loaned several times by different firms in succession such that the same share is reflected on the books of multiple firms as being owned by multiple parties, who all believe that they possess the same shareholder rights? Now, that's a lot. Susanne, I would be happy to give you the question and you can read it again or just answer it based on your understanding.

Susanne: No, I can answer it. I mean it's something I'm very familiar with, especially the first part. I think what needs to be made clear is that you say are the shares that are available for lending clearly identified.

Ralph: Right.

Susanne: In the depository system, which is where my knowledge is. Most of it is on the broker side, but in the depository side. The DTC actually has a procedure to allow the participants to recall shares that have been loaned in the event that they were loaned by mistake. If they were in your loanable account and you should have moved them and you didn't, there's a way to recall that. So it seems to me that if you have a procedure like that, it indicates that there's enough of a need for it, it's not really exception processing anymore. It's part of the system to be able to do that. So the answer then in that case becomes no, shares, when they come to the actual lending in that environment, shares are not clearly marked. And in fact, it happens often enough you have a procedure to correct it. And then I'll repeat what you asked me to repeat earlier, comes up again here. And that is how does one share end up loaned multiple times. So if the trade is settled with borrowed shares, the person who gets those shares, the buyer then, the ultimate investor buyer, takes ownership of those shares. They take ownership of the right to vote, of the dividends, etcetera. And there are no restrictions on those shares, so those shares can then end up back in a brokerage account and eligible for lending a second time. And that can happen repeatedly so that the same share ends up having multiple owners. One thing that enables this to happen that we'll talk about -- perhaps a little bit later we'll get into is the fact that you have what they call a fundable mass at the depository where all of these shares that are in existence in the United States are not earmarked individually. It's like dollar bills. All the dollar bills at the bank you certainly lay claim to some of them, but you can't -- when you walk into the bank they're not going to tell you, "Yeah, these five singles are yours and these three hundred dollar bills." And so it's the same way once a share is entered into the clearance and settlement system.

Ralph: Okay, I'm going to do some more questions. I'm just going to ask for shorter responses because I really have some other areas which are more complicated and they're going to take up more time and I want to make sure I can get through most of those. So let me throw a couple of easier questions out. If short selling provides liquidity, which is what I've heard, all of us hear that, short selling provides liquidity by adding sell side volume. Then why is it that all the stocks I get to see that are short sold tremendously, not one of them have gone up, they've all gone down. So, anybody want to answer that one? If you're adding liquidity in a rising market, which is why you short, then I shouldn't be able to see stocks all declining because that means there was no buy volume, there's strictly short selling going on. That's the way I would read that. Anybody want to take a shot on that one?

Male: I think that's simplistic.

Ralph: I know it's simplistic. I have a very simplistic way of thinking of things.

Male: First of all…

Ralph: I'll admit that. _____ credentials here.

Male: There are academic studies that show that oftentimes stocks that are short sold have weak fundamentals and two or three months later they go down in price.

Ralph: Right, no problem.

Male: But there are plenty of stocks that are on the reported list of a lot of shorting that don't go down. They go up and they especially go up when they're squeezed in a short squeeze.

Ralph: But if you never cover the delivery you don't get the short squeeze going. That's one of the problems. You have to cover shares. Once you start forcing people to cover the shares is when you get short squeezed. When I started in the business 30 years ago, that was the principal thing. Look at the short sale list, look whoever's short the most. Sooner or later somebody's got to come back in and buy those shares. Nowadays I wouldn't touch that theory on a bet.

Male: Well, I leave it to the professors to expand on this, but I don't think that all shorted stocks are going down.

Shapiro: Ralph, I think you've got to be careful to distinguish two situations. If you have proper short selling, it's certainly possible and there's plenty of research that shows many short sellers do their homework and they do spot companies that are over-valued and through proper short selling they drive the stock price down. They're really equilibrating the price with intrinsic value. Where the problem occurs though is when manipulation occurs. And what can happen is the mere selling pressure itself, particularly if there's naked shorting, there's no constraint on the short selling. You don't have to borrow the shares. In that scenario it's certainly possible that the added selling pressure would be the cause of the drop in price, not _____.

Ralph: That's where I'm particularly concerned. I think that's a phenomenon that we're seeing more now than what I've seen years ago.

Male: I think that's right. I think that's just supply and demand. If you have an increase in supply, the only way you're going to be able to induce buyers to take those shares is by having the price drop in order to absorb that added supply. And that's what's the really negative effect of the so-called strategic fails to deliver or naked shorts. They're artificially expanding the supply and artificially driving down the price.

Ralph: Okay, let me ask another question. _____ bankruptcy, I read that for some reason is part of it and it brought attention to an account that was known as securities sold, not yet purchased. I might have an understanding of it, but I'd rather defer to the experts. What does that mean? Anybody want to take a shot?

Anand: I'll take a shot at it. There are two types of transactions that are known as repurchase transactions and reverse repurchase transactions. A repurchase transaction is that a broker sells to another broker, "I take your cash. I give you my securities on the agreement that I will repurchase those securities." And then obviously a resale or a repurchase is exactly the opposite. This happens almost exclusively in the fixed income area. It's not done in equities.

Ralph: Okay. Is there a possibility that that category would also reflect naked shorts?

Male: Not to my knowledge. I thinkd Anan answered it.

Ralph: You think he answered it? So not yet purchased. I sold something not yet purchased. It seemed to me that maybe I draw a different inference.

Anand: There is no balance sheet that I know of that will reflect naked shorts. I mean, _____ short positions.

Male: _____ contingent liability if you say simply sell something and have it -- brought it back into the market. Don't you have a liability? So it has to reflect as a contingent liability somewhere. _____.

Cam: Ralph, can I make a point on Refco?

Ralph: Well, actually, _____ was first, then Peter.

Cam: Sure, I mean that sounds suspicious. But as regulators we have to go and investigate something. And I think that's what -- because a lot of times I'll just give you a sort of -- when we go out and do these compliance reviews sometimes, you'll ask a similar question on something simple like, "You sold 5,000 shares but you only had 4,000." "Oh, I oversold it." "Well, how do you oversell something?" And it's not really -- so until you go and actually analyze it and get the evidence, you can't charge anybody with anything.

Ralph: So then I should be comfortable that that kind of thing is looked at by the regulators in the normal course of their exam.

Cam: Like I said.

Ralph: And I'm perfectly happy with that. I think -- well, we want to keep you happy.

Because I'm sitting next to you.

Peter: Ralph, I'm going to make you uncomfortable here. That Refco account was down in Bermuda. It was not a regulated account, so I think Cam will have a hard time looking at that account.

Male: Well, maybe he wants to go to Bermuda. But these are questions -- I mean I think you're right, Peter. One of the troubling things as a regulator is you can pose these issues and these fact patterns and when you -- we are responsible for going in and actually analyzing the actual evidence and proving those cases. And sometimes you do run into the brick walls that are jurisdictional or whatever. So I think that's suspicious.

Male: And that's fine as long as we know we raised the issue, it's looked at and people understand it. We'll move on and say that we leave this in capable hands.

Male: One point to make that's really I think clear to people. There are two accounts that show up, one on the asset side of the balance sheet and one on the liability side. On the liability side, the securities firm is financing its own trading position. On the assets side, it's financing the positions of customers. This is absolutely normal and when you look at the income statement of these big investment banks, what you find is they make an awful lot of their money on the spread. It's the spread between the cost they pay on the financing and what they charge their customers. And oftentimes they actually generate more income from the spread business than they do from their normal trading operation. So I don't think that particular account on Revco's books, I don't know everything that was in there, but the mere existence of those accounts is not troubling. You'll find those accounts on every broker/dealer's balance sheet. But there are two, one on the asset side and one on the liability side. And they're roughly equal in size; one's a little larger than the other from time to time, but they're both there and you'll find that in every major broker/dealer's balance sheet.

Ralph: Okay, let me ask another. Let me shift into another question. These were the easy ones. All right, now this is just a hypothetical. I just want to know the answer. If this is true I really just want an answer because part of this is I have to learn something. Is it possible, say for a hedge fund -- I'll just use the word hedge fund just because it's an exciting term -- because it's certainly not me -- is it possible say for a hedge fund to maintain accounts of several broker/dealer firms and to have fails at the same issue in each firm? Okay and then if that's possible, is there any regulatory mechanism to identify that kind of practice?

Anand: I'll take that one, Ralph. Yes, in the prime brokerage arena, it is possible for a prime broker customer to have accounts at many different brokers. As you know in a prime brokerage, a customer agrees to have accounts at a number of brokers and with agreements to execute at other brokers. Yes, it is very possible that that customer can have fails in the same issue at a number of brokers. What mechanism do we have in place? I would have to go back to Regulation SHO and to the extent that that broker, if it's a member of the New York Stock Exchange, has an age failing(?) and that's where _____ security we would expect them to take action to clean up that account.

Ralph: Yeah but then what I was thinking, Anan, was that it's very possible that Reg SHO also said you're supposed to restrict that account from doing no further shorting. And the case is if I do shorting in multiple firms then it's very possible that -- I mean it's something, I guess, that regulators need to look at and put in to their mix.

Anand: Yeah.

Ralph: If that's a possibility, then it's the kind of thing, hopefully some good will come out of. People will notice that it's possible to be done.

Anand: Correction Ralph.

Male: Yeah, if it's closed out it's independent there, so that firm, that's got _____ participant non-referring(?) who has to close out immediately even…

Ralph: Yeah, but they don't know that there's a sale at another firm. That's the problem.

Suzanne: Ralph, does that amount in some cases -- you know where there's certain reporting requirements when someone makes a cash transaction of $10,000. And so there was people were making multiple $9,000 transactions. It amounts to the same sort of thing I suppose where you could -- one investor could have accounts in different places and just stay under a threshold at each one.

Ralph: They're getting _____ at the same firm. I've seen it before where one big institution at a firm has multiple accounts. You could short out of one account, be long in another one. And they're saying, "Well, they're different portfolios." I'm just asking is there ways that the regulators are at least cognizant of that and are, in fact, keeping that on their radar screen? And if the answer's yes, I'll go to my next question.

Jamie: Yes, that's certainly the kind of thing we'd be considering.

Ralph: Okay, great. Okay, this is a question I might -- I'll need to go to Anan on this one because Anan -- now I said I would never put anybody on the spot, but I really do need to ask you this one. The current system for buy-ins as I understand it, penalizes a broker/dealer if they make a buy-in because don't they -- if they get a new fail resulting from that buy-in, don't they go to the bottom of the list because it's the newest fail and if stock were made available it goes into the oldest fail first?

Anand: Well let me explain how a broker gets credit when that broker executes a buy-in. The Commission has issued a Q&A giving trade date credit and what that means is that if a broker has a fail in a threshold security and executes a buy-in on the 11th, 12th or 13th day, that broker gets immediate credit in other words for clean up of a threshold, a fail to deliver any threshold security. On the trade date, where the buy-in is executed, it's subject to one condition that the broker affect buy-ins at least, purchases at least equal to the open fail to deliver on the prior date. Outside of trade date credit, if a broker executes a buy-in, obviously it will affect or impact that broker's net fail to deliver three days later on settlement date. There is nothing in the regulation that speaks to whether or not that buy-in can be applied on the oldest or the earliest fail. I will tell you that during the course of our examination that we found a practice that we call spiteful methodology, where if a broker has a net reduction in its fail day over day, they have been applying it to the very earliest fail. So in other words, that will generally cause the aging of a fail in a threshold security to expand out.

Ralph: Okay. I have to tell you _____. Okay, I guess this question I wrote. I'm going to actually try and think why I did it. I was asking a question about a broker/dealer, could a broker/dealer lend shares out to another broker/dealer if they were having -- needed to borrow shares for their position. Is that the process known as ex-clearing?

Male: I think that practice is called on-lending, broker to broker for a customer.

Ralph: Yes, broker to broker, that's called on-lending? And is that -- that's not reflected in the clearing.

Dr. Trimbath: No.

Ralph: Dr. Trimbath?

Dr. Trimbath: It depends. Well, there's actually a online program where one participant can make a free delivery to another and usually it's the loans taking place ex the depository, ex-clearing and settlement, as you say a broker to broker transaction.

Then the lending broker simply makes a free delivery, a delivery not with payment, without payment, to the other participant and then they handle the payment outside. You can also enter delivery versus payment that's not a trade, but it's just I'm sending -- take shares from account A, give them to account B and then process payment from account B back to account A and that all ends up as part of the settlement system at the end.

Ralph: I thought I wrote this out. Okay, now, if a broker does that, broker to broker, is that still recorded as a sale, because why would the one broker ask the other broker to loan it to them because there was a sale or going to be a sale, correct?

Dr. Trimbath: For many reasons. That's one, maybe.

Male: I don't know why else we would lend the stock to the other broker.

Male: Because the other broker has someone who wants to short.

Ralph: Okay, but that's -- okay, right. So they gave the stock…

Male: But then it gets recorded as a stock loan transaction.

Ralph: It's a stock loan transaction and as long as there's no fail it's off the record, so that's just strictly what they call the stock lending business of the broker/dealer, another way to make additional funds.

Male: Yes.

Ralph: Are there no end to the ways to make funds from us? So if my shares were loaned out, would I be notified that my shares were loaned out?

Male: No.

Male: No, not that I'm aware of.

Ralph: No? I didn't think somebody would tell me that. So if I'm not getting notified, I'm not getting compensated. Meanwhile the broker/dealer's making the money by lending out shares.

Anand: Yeah, but Ralph we cannot -- I have to go back to the Customer Protection rule which Professor Angel spoke on earlier. And the rule is there for a valid reason. The customer fully pays for an excess margin security, securities that are greater than 140 percent of the balance, must be locked up. That broker must take possession or control. And keep in mind that 15c3-3, the Customer Protection Rule, the other section of the rule applies to customer's cash, credit balances. A broker must lock up with fully paid qualified securities, or cash in a bank account that cannot be subjected to a lien to cover its net payables to customer. And when we review a firm, I'm responsible for a unit that conducts financial operational examinations, the Customer Protection and Net Capital rules are a huge part of what we do every day. Every day a broker has runs what they refer to as an Excess Deficit report to determine if they have a deficit in every single security and whether or not they must recall a stock loan or a bank loan and if they are deficient with regards to position and control requirements, those rules are taken very seriously and we review every single member organization that's a clearing organization when we go out and conduct examinations.

Ralph: Thank you, I really do appreciate that, Anand.

Male: Ralph, you understand if you want to get paid for that stock, have it kept at a bank.

Ralph: Who's you when you say you?

Male: You said nobody tells you when they loan your stock out.

Ralph: Oh, me, the customer.

Male: Yeah. So I'm going to help you. Have it kept at a bank and they will lend it out. They'll tell you and they'll pay you for it. And you probably have to have $10 million or $20 million worth of shares but…

Ralph: But I'm…

Male: If that's what you want.

Ralph: I'm short of that right now. No really, I checked my account.

Male: No, no, seriously. That's where all the stock is that's being lent out. It's not in these piddly margin accounts. It's pension funds and educational institutions that have this stock at a bank and in addition to earning money from the stock appreciation, they earn money from the stock loan.

Ralph: I'm going to ask -- these questions are going to get a tad more complicated in some measure. So we're certainly okay. I've got to move along. Okay. I've read that the total number of fails that are actually bought in are less than one-tenth of one percent. I think that was in Professor Boni's report. Is that correct?

Male: Well, it was an examination of the transactions of one major market maker. And of the -- my memory -- 69,000 fails that were reported by that market maker, I think 86 were force bought in.

Male: _____ adoption _____ hedging in the cash market.

Ralph: So, is that actual that there's less than one-tenth of one percent that was actually bought in?

Male: That would be equal to a little more than one-tenth of one percent, right, for that market maker.

Ralph: That seems relatively low.

Male: Yes.

Dr. Trimbath: But what's funny about that is that there are 96 stocks from fails. I mean we claim to have T+3 plus settlements and get this number of trades that don't settle, that fail to settle. It's just stunning.

Ralph: I'm going to ask you that question. Let me go on to that because I was saying looking at the number of buy-ins that was less than one-tenth of one percent, I'm going, "That doesn't sound like I'm impressed yet that there's a lot of buy-ins going in on the market for the shorts." But I also read elsewhere that -- and I just say DTCC, I think it was, that made a statement that the total fails to deliver are running about 24,000 transactions daily out of 23 million new transactions or about one-tenth of one percent. It said having a dollar value amounted to some $6 billion daily in the shorts, but yet if you look at it in the overall perspective of it's trillions of dollars worth of value, that it doesn't seem necessarily that significant. And I'm not trying to paraphrase that. I am paraphrasing it, but I guess the implication was if you're only having 24,000 transactions and it only has billions of dollars of fails a day when we're looking at trillions, how significant is this? So I guess…

Dr. Trimbath: It's only $6 billion a day, but sooner or later it adds up to real money.

Ralph: Some senator said that once. I remember that. But I was also going to say that according to my note here it said that the percentage of fails relatively hasn't changed in the last ten years. So I guess what I'm going to do is ask a few of the professors to tell me is this a relatively significant number and do we need to be concerned with that level of fails?

Shapiro: Well, first of all, the $6 billion in outstanding fails on any day is equal to about seven percent of the value of daily trading, at least at the time that that $6 billion figure was given out by the Deputy Counsel of the DTCC. But our information on -- for many years we really had no data at all, no public data on the extent of failures to deliver. And the first real data we got was the analysis by Dr. Leslie Bonnie(?), who is a visiting Economist at the SEC and was given -- the first academic to be given access to the DTCC records of failures to deliver. And she picked three random days and examined the levels of fails on those three days. And what she found was that there were -- first of all there were pervasive fails in the sense that most stock had at least small fails. And that's easy to explain if it's a fail of a day or two. But then she looked at extended failures to deliver. And I think everyone agrees that that's the phenomenon that we're really concerned about, not a fail that can be explained by a bookkeeping problem, difficulty locating a share, a signature in the wrong place, but one which goes on. And what she found was that on any day within 1,000 listed stocks, which would be about fourteen percent of listed stocks, had failures to deliver, that it persisted for at least one month. And that more than 700 listed firms, that would be ten percent of listed firms, had fails that had persisted for at least two months.

Those are not bookkeeping problems. That tells us there's some significant problem and that those extended failed to deliver were substantial. Among the fails according to Dr. Boni's analysis that had gone undelivered for at least 2 months, 40 business days, they amounted to 60 million to 120 million shares. Now if you put that against all the shares on the listed exchange, it's not much. But it's not distributed randomly. We know it's highly concentrated. We know that from the Reg SHO list tells us that. So this is there are, I think, that I -- as an economist I can only see two explanations or the existence of large scale, very extended undelivered shares. One is, and this is Dr. Boni's explanation for much of it, is that these are strategic or deliberate fails. That is, some large customers are being permitted to do this in order to avoid paying the cost of borrowing. And we've heard that story in various versions with the markets over the last ten years. And the other possibility logically is that the extended fails are not strategic but are to some extent, some of them are being used to drive down the price of the stock. That was a phenomenon that we say -- we believe we saw, anyway, repeatedly in the late '90s in the instance of death spiral financing, a particular form of financing which created an enormous incentive and opportunity for large scale naked short sales. And in an examination, I've looked at 355 companies that accepted the financing and virtually -- and on average, adjusted for market movements or the overall movement of the market they on average lost between 65 and 70 percent of their value in the 12 months following the financing. Now, it may be they were all dogs, but the fact is the structure of the financing created the incentive and opportunity for naked short sales. This is people went to jail for this. A couple people, not many. So we know there is a -- we have significant examples of extended large-scale naked shorts being used to manipulate stock prices. We don't know from Dr. Boni's analysis, we can't tell whether this is in her terms strategic failures in order by large customers to save money or whether it's manipulation. We have seen instances of both of the paths. So I think we can fairly say that either possibility is real.

Ralph: Okay, the phenomenon that you were referring to, isn't that known also as the death spiral financing?

Male: Yes, that's -- in the late '90s. Death spiral financing is no longer done. It's so that the failures, the extended failures which Bonnie picked up, which all came in her three days worth, a day in September, a day in November in 2003 and a day in January of 2004, there were virtually no more instances of death spiral financing.

Ralph: Okay, now death spiral financing, I guess one of the papers I originally read on that subject matter was by Professor Finnerty. So Professor, would you mind giving us a little bit more insight on the death spiral financing.

Finnerty: Sure, the _____ convertible security and in a typical convertible security the holder has the option to exchange the preferred stock of the note for shares of common stock at fixed price. And with the floating price security, the price that is used for conversion purposes is indexed to the price of the stock trading in the market. Years ago there was a study done by a couple of very well-respected economists that pointed out this could be a very attractive instrument to companies that believed that their fortunes are improving and that the value will increase because at the time of conversion the share price would be higher and they would issue fewer shares. So from a corporate financing standpoint, it may appear as though this is an attractive security. What typically accompanies this we find though is you're not just offering the issuer the opportunity to sell this convert. You're also typically offering them an equity line of credit at some enormous amount, sometimes exceeding the entire equity capitalization of the company with a very high price threshold. And the offer is that if your stock price is above this threshold, then you get to tap in this equity line. The transactions I've looked at, I don't think I've found more than one or two out of a couple hundred where that line was ever tapped. The share price, in fact, just plummets. The floating price converter death spiral security is really the perfect storm in corporate finance because, as I've said, the issuer may think that this is an attractive instrument because he believes that he will issue the shares and then will convert at a higher price and issue fewer shares. And in fact the reverse happens in 99.9 percent of the cases. And as Rob has said, in a very high percentage of those, the share price just follows the old ski slope right down to zero. And one of two things typically happens, the company goes out of business because any reasonable lender looking at this will say, “This company’s on its deathbed. Why else would the share prices decline?” It can’t get financing. It goes bankrupt. And when the shares are cancelled, then the short seller never has to cover his short position. The alternative situation, which happens in a small number of cases, is that it’s a really good company and it -- I’ve looked at a well known published study by Hellion(?) and Vermillian(?) and in fact found there’s a very significant percentage of these issuers that are by any measure good companies. It’s less than half, but they’re good companies. What happens in some cases is the bad guys drive the price of stock down, get so many shares on conversion that they get enough to control a position, come in, throw out the management and take over the company. Share price miraculously rises back up to its intrinsic value. So these are, I think, the perfect storm because the issuers go into these transactions with one set of expectations and rarely, rarely are they fulfilled. Let me correct one point that Rob made. He said this is no longer being done. Unfortunately, that’s -- they’re back. Now they’re not back in the same size, but this is an instrument that is a favorite instrument of manipulative short sellers. They love this instrument. It gives them perfect cover because they can go in when they’re challenged and they can say, “We were short selling to cover our risk.” And that’s not true. The floating price feature gives them the perfect hedge. They don’t need to short sell. It gives them perfect cover. These are typically priced with a very large discount so a buyer, if the buyer in fact does get the shares and can sell them, the buyer can typically earn rates of return of 25 or 30 percent in a very short period of time, sometimes as little as a few months. These are enormously profitable and as a result they are -- and because they provide good cover, if you’re challenged on what your strategy is, it’s a manipulation vehicle of choice.

Ralph: It’s not actually the naked short selling, but what it is is a downward manipulation and it’s one of the areas that we looked at at the state level about companies needing financing. And I think the target range of the companies we looked at were 3 to 5 million.

Finnerty: They’re typically small. But be aware that what often happens with these is the short selling, the naked short selling of companies, it follows the issuance of securities. And where you see it is there’s typically a pricing window of about 10 to 15 days and the price for conversion for a business is based on a formula that’s maybe the lowest three out of five or five out of ten and pick your favorite numbers. And not too surprisingly what you find is there’s an enormous spike in the trading volume as soon as that window starts. And there’s enormous selling pressure. And that price just plummets during that period. Once that pressure's off and the shares are delivered, the price starts to rise a little until the next conversion notice comes and it drives it right back down. So this instrument is virulent because it's accompanied by naked short.

Ralph: Yeah.

Finnerty: The two go hand in hand.

Ralph: And the reason why we wanted to bring it up at this particular session was to make sure that the CEOs of companies and the financial press do give notice and warning to companies that are trying to seek to raise capital to be very cautious about this kind of a practice because I think a lot of companies are, in fact, being destroyed. What I'm told is that the companies could have got -- they can't get significant financing, so they're in the 3 to 5 million range, which is relatively small. But what happens is once you start driving the stock down, then they have no availability of capital through any other source.

Male: Let me say that in the '90s when this was widely practiced, there were a lot of much, much larger companies.

Ralph: Okay because I can tell you…

Male: And today if it's back, it would be -- it would have to be companies that are -- that don't know the history and they're consequently very naïve about it.

Finnerty: I think that's right. I think they are. I think that's correct. So the message for people who are listening is avoid these things like the plaque. These are highly toxic and if you issue these securities, you do it at your company's peril.

Ralph: Okay, let me ask a question just not related to this because I just don't know the answer, maybe someone in the panel knows. But when a company -- say you're doing a shorting. And then at the end of the shorting you need to cover that short. Right?

Male: Right.

Ralph: Okay. For tax purposes you get a 1099 when you generally buy a security and you sell it at a brokerage firm. Now what happens? I believe if a company goes bankrupt you don't have to cover the short.

Male: If the shares are cancelled in bankruptcy, you do not have to cover.

Ralph: So when then do you report for your tax purposes that you made all this money all the way down?

Male: You would report it -- I believe -- what I'm told by tax advisors is you would report it as a capital transaction in the year in which the company liquidates. You just have evidence that the company liquidate or if you sold the shares. What often happens in the company is shares are down to the pennies range. You typically arrange a sale so you can close it out. Ultimately it gets cancelled out. But the direct answer to your question is it's a capital transaction that you would close out and report in the tax year in which the company was liquidated.

Ralph: Yeah, but I reported mine. I have two companies that actually went bankrupt because -- that's a reason I'm a regulator now and not an investor. But two of them went bankrupt and I had every incentive to report because I wanted to take the tax loss. But if I was shorting all the way down, do I have the same incentive?

Dr. Trimbath: If you sell the shares short -- let's say that the cash comes into your account and presumably you don't close that transaction until the point at which you purchase the shares to replace, right, and if, as the scenario that John Finity(?) was describing, that never actually happens because the shares become cancelled with bankruptcy. So then, John, under those circumstances, you were describing it as if I were the purchaser of the stock. But here we're talking about I've already sold the stock. So I'm not going to sell it again when it gets to pennies because I've already sold it when it was dollars.

Ralph: Maybe we'll leave that question for the tax experts to look into that one on the…

Male: Could I -- you don't report, your broker/dealer reports.

Ralph: Do they report? I'm saying…

Male: Yes, well they report two sides of the trade. They report the sale. They may not report the purchase, unless they do that special thing.

Ralph: Well, that's what I was saying. So on the purchase side, especially if there's a bankruptcy, there's no covering that.

Male: If your point is the IRS is not going to know, the IRS is going to have at least one half of the trade.

Ralph: Well, that's good.

Male: But the broker…

Ralph: They get two halves of mine, can't they get two halves of the other people?

Male: The broker statement will show that the company liquidated, the shares liquidated. It will show that and the shares were cancelled. That shows up on your brokerage statement. I don't know about the cash flow, but that part of the transaction.

Ralph: Well, you know what, like I said, we'll leave that to the other experts on another day. But at least it might want to trigger somebody to look at that issue.

Okay, Larry Thompson, who I knew from the DTC, I think is the General Counsel of the DTCC, he was quoted -- I'm actually just going to read a particular quote that he made in response to a question. The question was, "Why won't you reveal the number of fails to deliver in each position to the issuer of the security?" That was the question that was asked of Larry. And he responded, "There are a couple of good reasons why we don't do that. First, we provide information to regulators and the SROs so they can investigate fails and determine if there are violations of law. Releasing the information may jeopardize those investigations and we don't think it's appropriate. Second, NSCC, which is the National Securities Clearing Corp, rules prohibit release of trading data or any reports based on trading data to anyone other than participant firm regulators…," I have to come back to that, "…or self regulatory bodies such as the NYSE or NASD." This is reporting the fails. Do you really think that fails -- I don't know number one, where it says regulators, I assume that covers state regulators. I'm not sure that term means that. That's something I might ask. But _____ that question. Shouldn't the fails be reported, the aggregate fails? There's no reason why, it seems to be, that if you're going to report the shorts, why can't you report the number of or the shares that have failed to have been delivered. I know if I'm the CEO of a company and I've got shareholder concerns, they want to know how come the stock's going down, the stock was shorted, isn't it also good for transparency in the market to be able to say, "These many shares have been failed?" There's no proprietary information because we're not saying, "Bob shorted this many and Bill was shorted that many." We're simply saying the aggregate fails in your stock. Anybody could tell me why that probably is a bad idea or a good idea?

Shapiro: Well, it's…

Ralph: That's Dr. Shapiro, go ahead.

Shapiro: I think you have to assume that it's a good idea because the more information there is in the market, the more efficient the market becomes. And so it's hard -- I mean I was very struck by your -- by the quote from Mr. Thompson.

Ralph: It's actually here. I read it, because if I read it wrong…

Shapiro: He says that NSCC rules prohibit release of trading data. The NSCC is part of the DTCC. So you say, "Well the reason that we can't do it is we have a rule that we can't do it," which is not very persuasive.

Ralph: Professor Angel?

Angel: Yeah, I'd like add that the transparency that you're calling for is essential for restoring the reputation for integrity of our capital markets. There have been enough allegations of problems that we need as investors to be able to figure out on a stock by stock basis whether there really is fire or whether it's just smoke. And unless we have the data we can't figure that out. So we definitely need more transparency about the rate of short selling. We need more transparency about failures in the market. Now, how and when and in what form, that is going to be a very interesting issue in that I suspect part of the reluctance to release that information stems from a fear that, "Hmm, if we let everybody know there's a big failure, then the fast players on the other side are going to try to squeeze the party that's failing, blah, blah, blah, blah, blah. Are we really playing into the hands of manipulators, blah, blah, blah?" So I can see why they would be reluctant to do anything. Besides, it's more work for them and who wants to do more work? But still, we need more transparency in these markets so we can see whether or not there is a problem on a stock by stock basis.

Ralph: Thank you. I'm going to go to Professor Finnerty and then I'm going to shift into another area of -- you know what, I need to -- okay, I'll cover Dr. Trimbath because then I want to go into the area of shareholders and voting and that type of issue.

Finnerty: The reason why I think it's deeply important for the companies to know about the fails to deliver is because of the risk that what gave rise to it is in fact a true fail, that is there is a real failure to deliver shares which has given rise to so-called phantom shares. In other words, what happens is the clearing system will jump in and essentially cover that trade by issuing a commitment and that commitment is often showing up on the broker's dealer statements. And a CEO ought to know that because what happens is the number of votes that shareholders think they have may far exceed the number of shares that are actually outstanding. And fails to deliver exacerbate that problem because there is no limitation on short selling. So you can have the number of votes, 40, 50, 60 percent or more above the actual number of shares outstanding and a CEO is going to want to know that, that he's got a lot more people out there who think they have the right to vote shares than do. He's got a fiduciary duty to all his shareholders and he wants to know how many people are sitting out there who think they have rights that they don't have.

Ralph: Yeah, I really appreciate your comment because I was going to pursue a question, follow up question with Dr. Trimbath which was actually the very same question about do securities immobilizations exacerbate the problems created by the fails. So what I'd like to do is I might as well pose the second question to you and ask if you would mind spending a few minutes to cover this issue. What does the industry say about the consequences of stock lending for shareholders voting rights? Okay?

Dr. Trimbath: So the -- well, yeah, I mean…

Ralph: Yeah, the buyer of a failed delivery had the right to vote. That's another question I guess. You can cover those three.

Dr. Trimbath: There's actually an article in the package that you got today, an excerpt from a securities transfer association's newsletter. In the last proxy season, one transfer agent reviewed 341 equity issues to see if there was attempted over-voting, which would indicate that more than one person was trying to vote the same share. And they found that to be the case in every issue they examined. The full newsletter article is three reasons why that the SCA(?) is, in their analysis, understands that this is happening, one of which I've excerpted for you here, which is over-voting as a result of stock loan services and trade-related situations. What happens, again, this -- two people end up thinking they own the same shares. As the number of shares multiplies compared to the number of shares that are there, the seriousness of the problem is that when individuals own shares and believe, either through their broker because your broker gives you -- you leave your shares with the broker and you believe you're giving your broker, the brokerage then turns it in. And even affects those shareholders who have direct registration don't have this problem, but those, if the shares are left at the broker and the broker is turning in votes, if the broker only has 1,000 shares on deposit and sometimes they have 2,000 votes, they may or may not even divide up the percentage for and against certain proposals. So and that problem is not necessarily created by immobilization, but it's enabled by immobilization. So you have a system that, again, go back to the idea that you have a system that accepts accidents and views that innocent fails, if you will, then that's a system that enables someone to manipulate that.

One way that individual shareholders can assure that they are not part of -- that they actually have one share, one vote and that their registration is secure, is through a program called Direct Withdrawal at Custodian. And that allows you to have your shares on the books of the issuer so that you have registration where your vote counts and your dividends come to you directly. But it reduces the risk that the individual would have from holding a certificate and it also provides you other liquidity.

There is a way for investors to protect themselves if they can hold their shares directly with the issuer as opposed to leaving them in the broader system where the potential for manipulation and loss of voting rights, real voting rights, not… By the rule you have your voting rights, but when it comes right down to it, there's too many votes going in for one share.

Anand: Ralph, let me add one comment on the proxy matter. The New York Stock Exchange conducted a number of special exams during 2004, based on a survey we had conducted regarding proxy processes at a number of our member firms. And we did find widespread problems regarding over-voting and that was essentially because through Dr. Trimbath's comments, firms weren't necessarily taking into consideration what we refer to as the short side of the stock record, so essentially voting the entire wrong side of the stock record without taking into consideration securities that might be out on loan and things like that. And we also issued an Information Memo _____ 454 in November of 2004, really putting firms on notice, broker/dealers that are members of the New York Stock Exchange that said there are obligations with regards to proxies.

Trimbath: And if we could just ask a directed question to the NYSE, there maybe about sort of an old school thing that there was a one share, one vote rule for listing at the New York Stock Exchange. Is that still in place? And how do you reconcile that with over-voting?

Anand: It's still in place but there is a special committee and I'm not too familiar with it because it's on the business side, so to speak. Our rules, I think they are 451/452, are business side rules. And there is a committee working right now to look at our proxy rules and with the possibility of amending those in the future.

Ralph: Dr. Trimbath, let me go back to that, shareholders, the voting rights for a minute. I unfortunately glanced at some other papers and lost a little bit of what you said, so perhaps this is just for me, but are you saying that in not all instances when I vote my hundred shares of whatever I have, that at some point I actually may not be voting a hundred shares?

Trimbath: You can turn in votes for 100 shares.

Ralph: Yeah, I've got that part because I did that. I mail it in.

Trimbath: Right. So if those shares are registered in your name…

Ralph: They're actually through a brokerage house.

Trimbath: Okay, so you send in 100 and the broker puts all those votes together. And let's say that they have a million votes. They may only have 500,000 shares on deposit at the depository backing that up because certain shares have been loaned or they've borrowed shares, whatever. And when that happens, then when the broker -- this is with the transfer agency is that that broker is now submitting a million votes against a 500,000 share position.

Ralph: So what -- yeah, I'm -- well, okay.

Trimbath: And so what do they do? So what do they do?

Ralph: Right.

Trimbath: At the brokerage firms, the people that I know who've worked a brokerage firm will tell me that they will allocate the vote. So the best case scenario is of the million shares that they got in, sixty percent were for the proposition, forty percent were against. And so they just make that allocation across the 500,000 shares they actually have. So they vote 60 percent against and 40 percent for, whatever the ratio was.

Ralph: Huh? Fundamentally that's wrong. If I have 100 shares of stock…

Trimbath: That violates the one share, one vote because…

Ralph: I mean, yeah, and I really hate to sound like I'm a little indignant about it but we fight wars over the concept of we want people to have one vote. You want a vote, so when you take away half of my vote or some percentage of my vote, shouldn't somebody be telling me that upfront, that I may lose a percentage of my votes? What about all what I read about in corporate governance, where people talk about corporations trying to sit there or institutions? There are a substantial number of financial institutions that want to make their voice known about corporate governance. You're saying that all their votes don't all count equally?

Trimbath: Well, they actually recount -- the SCA(?) recounts a situation where an institution attempted to vote shares one way that had been voted in a different direction by the DTC member, the broker/dealer that was holding the shares for them. And in that case, the proxy agent only counted the votes that came directly from the DTC member, from the depository member, not those votes that came from the institution because they didn't have the paperwork in place to show that a proper proxy had been processed. So there is a situation where the alternate shareholder, even an institutional shareholder, not just individuals, individuals are affected, you and I would be affected by this, but the institutions from large pension funds and mutual funds can also be affected by it if the shares, they want to vote one way and the shares are then voted in a different direction.

Ralph: Why have I never read anything about this?

Trimbath: I read about it…

Ralph: And I read a lot of stuff. I have no life. I mean, I actually read these things.

Trimbath: I think, you know, a lot…

Ralph: Why isn't that a…

Trimbath: Well, hopefully there's someone here today that's going to put that in a place where people like yourself and others can read it and learn about this.

Ralph: Well, I hope so. I -- okay, but you know what? Let me thank you for bringing that up. I'm just a tad disappointed with the industry right now. No, disclosure is the fundamental rule of how we exist, okay? I mean that's what everything's based on.

Trimbath: And the economists…

Ralph: If I can't trust -- if you don't trust that, you undermine the capital market system, the entire economy.

Trimbath: And Ralph, that was the comment that I'd like to make regarding the quote that you had from Larry Thompson at DTCC. I know that you invited them to be here today and that they declined the invitation. And having worked at the depository, I can say -- and not to defend them -- but I can say that from their standpoint, it's problematic to release the information because once people know the magnitude of the fails, once people know that the shares that they are holding at their broker are not being voted the way that they think they are, then this becomes problematic in the sense of having the potential, at least to undermine faith in the system. And one of the founding reasons for having a depository, one of the main reasons for immobilizing securities is to provide safety and security in the system. And so that could be -- that underlies the comments that they make about not wanting to release that data. However, the economists on the panel, myself included, will tell you that information, full information is part of efficient capital markets. One of the underlying assumptions is that information is free and freely available to everyone.

Ralph: Thank you, I really, I appreciate your comments. Somebody could help me again. I recently read a press release from a company which was traded on the bulletin board and the company claimed that its shares were now listed, unbeknownst to the issuer, that the shares were now listed on the Berlin Bremen Bourse, where the company shares were then subjected to significant short selling. I am not sure how pervasive the problem is. I am not sure what steps are taken to stop that kind of a practice. If US listed securities can wind up trading on a foreign exchange and then be shorted over there, if it could happen to a bulletin board company, it could certainly happen to a lot of the other companies traded on US markets. Now I'm going to go to Professor Angel because he made the observation. You had actually visited 44 stock exchanges?

Angel: Yeah.

Ralph: Thank you. Could you answer that question?

Angel: Sure, I've actually been to the Berlin Bremen. And basically they'll trade anything that looks like a stock there. So it's not like there's a particular conspiracy going on there. But all it means for a stock to be listed in Germany is some German broker said, "Hey, put this onto your list." It's not clear they necessarily have any trading volume there, but basically as a matter of fact the Berlin Bourse is proud of the fact that they trade just about every stock that trades in the United States. Now, if a manipulative entity wants to evade enforcement actions, one of the ways to do that is to put barriers between yourself and the regulators. So by jumping across borders, you make it that much harder for the cops to catch you.

Ralph: Yeah, because you could do an offshore hedge funds doing business with Berlin. You've got the same fails. You've got the significant shorts.

Angel: And it can be done in Canada. It can be done in Germany. It can be done in just about any offshore jurisdiction. You just make it that much harder for the regulators to catch you.

Ralph: And then how do you do the clearing? Cam are you going to be able to answer that question?

Cam: Not the clearing. But let me just make a comment. I too have been to the Berlin _____ too. And last year, a year and a half ago, there was a lot of press about naked shorting in Berlin and companies very proudly were saying, "We're listed on the Berlin" and then two weeks later, "We're trying to get off the Berlin." We took it very seriously at NASD. I actually went over to Berlin with a team of people, sat down with the folks there, learned what you learned, that a listing on Berlin is not like listing on the New York Stock Exchange where you apply. We haven't seen one instance, not one instance where there was any evidence of illegal naked shorting or any other type of manipulative activity involving the Berlin Stock Exchange issues. And if you have one, send it to me. But I haven't seen one and I'm pretty actively involved in this area. So I think just to clear that up.

Ralph: One where the company claims that they were short?

Cam: Well, lots of companies claim, as you well know, anything. I mean, people claim all kinds of things. The short sellers say the stock's being manipulated up. Long holders say it's being manipulated down. That's your life as a regulator. One of the things we did in response to this almost hysteria about Berlin listings is, and you can look at NASD website, we put out a very specifically-worded interpretation of bona fide hedge positions because that's really the technical term that was being used, that the bona fide hedge was being abused. If you go to our website, we crafted a very specific interpretation of bona fide hedge to alleviate any fears that that was going to be tapping(?) or it was legal. And we actually haven't heard after that any of the allegations out there. Occasionally you'll hear something, but we haven't seen on shred of evidence that that's true. So if anybody has any, feel free to email me or call me.

Ralph: I'm going to ask Professor Trimbath one question, then I'm going to wrap it because I think we're running on. I need you to help me. I can't hear, I'm partly deaf. Professor Trimbath…

Trimbath: Yes?

Ralph: What about the clearing on the transactions that are occurring on the Berlin?

Trimbath: I would assume that it's similar to what we have here and that is that when the trade takes place part of the information that's included in the trade is where settlement will occur so that the trading partners can designate where they want settlement to take place. About twenty years ago, the International Society of Securities Administrators made a recommendation that each country have one clearing settlement organization and one depository. So in the US we have DTCC, which is DTC and NSCC. There's also Euroclear and Tidell(?) in Europe. And so although they've done some mergers in the last five years or so, but I would assume that they -- and those -- worldwide those depositories are linked to each other. So you could be in Europe, anywhere in Europe, designate that a trade settle at DTC, actually deliver certificates or shares or whatever you had to in Europe and they would be booked and removed to the accounts in DTC for settlement in New York. So those systems have all been linked together.

Ralph: Okay. Let me just ask a general question. Maybe, hopefully something will come. What can be done to help eliminate the fail to delivers? Jim, I'll go to you first and then I'll go down the line and see if you guys have some suggestions you'd like to make to help eliminate these.

Jim: Yeah, well, first of all, yeah, I think today's discussion shows there are really three types of failures. There are the innocent failures that, "the check is in the mail," that resolve themselves almost immediately. That's why the system gives people the leniency that it does. The second type are strategic failures of investors who want to go short. They look at the difficulty of borrowing stock and they decide it's cheaper to fail than it is to borrow the stock. This indicates that our stock lending system is broken and we need to pay a lot of attention to the inefficiencies in our stock lending market and especially to government regulations that provide barriers to more efficiency in our stock lending market. The third type of failure are the manipulative failures from players who have no intention of delivering the stock because they are intentionally trying to drive down the price. That's where we need better enforcement. So what we basically need is we need a better stock lending market because most of the -- a lot of these failures are because of inefficiencies in the stock lending market and if we improve the stock lending markets we will get rid of a lot of these failures. And when there are manipulative cases, we need to make sure that the enforcers are on them and on them quickly.

Jamie: And Jim, to that end I'd use my time to answer two questions from the audience. Have you explored how much of this activity is from the dealer community, i.e., market makers? I assume by activity the questioner means abusive or violative(?) naked short selling. And I want to point out that the SHO closeout requirement does apply to market makers and if they violate that, they will be subject to the consequences. And also, the locate exception for market makers only applies where its bona fide market making and not speculative investing or certainly abusive trading. And I know Cam may want to address that as well. Also, a question, there is no margin requirement when a ticket is marked long and never delivered and is actually a short sale. Well, SHO has a marking requirement that it would be a violation to mark a sale as long and have it be a short sale. And that also is the subject of examination and as necessary disciplinary action.

One final thing I wanted to mention is that there's been some thoughtful comments here today and as we go forward and administer SHO, we'll take those, we'll carry those with us and of course any further regulation will be subject to the notice and comment process and we look forward to more input at that time.

Ralph: Peter? Well, I'll go down the line.

Peter: The NASD has their own version of SHO out for comment and I understand why they chose to follow SHO, but they could be a lot tougher and they could impose a pre-borrow requirement on all threshold securities or they could penalize someone for a 90-day period and be required to pre-borrow. So if you're serious about this, comment on this proposal and just say, "Make it tougher."

Ralph: Professor Finnerty?

Finnerty: I would recommend three things. First, require that shares be borrowed before you short. Secondly, require enforced three-day settlement and if they fail to settle within three days, you've got a forced buy and let's say ten days -- seven days, ten, pick your favorite number, but there comes a point in time where you really have to buy-in. And thirdly, I think the fails have to be -- should be reported and the short position should be reported on a daily basis.

We do not report shorts the same way we report longs and I think we should have symmetry in reporting. And the only way to solve this problem ultimately is better enforcement but also better reporting.

Ralph: Okay. Cam?

Cam: I'll tell you some of the things we're doing that go a little bit towards that direction. You might not know but we've filed a rule to extend short interest reporting all the way down to the OTC market, which you don't have now.

Ralph: That's from one of our panelists, so go ahead.

Cam: I'll give you your check after this. So we're doing that. It's unfortunate and you know I work very closely with the SEC on a lot of issues. And it's unfortunate we can't talk about all the things we have under investigation or are reviewing. So we're a little bit restrained from what we can tell you. But I can assure you both the SEC and the SROs are very aggressively investigating these issues, both from a compliance standpoint and from a fraud standpoint and hopefully you'll appreciate that when you go interview people on these issues, they don't confess, which puts a lot of burden on people who actually need evidence to prosecute. So we're out there actively working for you and trying to pursue both the Reg SHO compliance issues and other fraud.

Ralph: Okay, Anand?

Anand: Couple of things, Ralph. As I alluded to earlier, we have a very rigorous examination program that's applied to every clearing firm that's a member of the New York Stock Exchange. And we've been conducting those examinations throughout this year. In addition, Jamie alluded to some special examinations we've done. The New York Stock Exchange has done a total of nine special examinations this year to ensure that our firms are applying the rule of ethic which is intended. In addition, we adopted Regulation SHO as part of our rule in its entirety, our Rule 440C. In addition to examinations, we -- and I demonstrated this exceptional voting system we developed to you, Ralph, a couple of months ago I believe, where we monitor and track the level of fails at each of our member organizations in threshold securities on an ongoing basis. And to the extent we determine that a member of the New York Stock Exchange has an aged fail in a threshold security that it has not taken action to close out, we get in contact with those firms and ask what action they're taking. This we do throughout the year in addition to our examination program. Lastly, the number of securities on the New York Stock Exchange listed issues on the threshold list when SHO became effective, when the threshold list was first published on January 10th, was some 78 or 79 issues. It's now down to 40. And we are experiencing consistently over the last several months just about one percent of all the traded issues on the New York Stock Exchange. So I've got to believe that our surveillance examination program and the regulation itself has had an impact.

Ralph: Dr. Shapiro?

Shapiro: Well, I certainly agree with Professor Finnerty and Professor Angel's proposals of how we could address it.

The way you stop it is by stopping it, by requiring pre-location by not permitting the withdrawal of funds on a marked to market basis for any transaction in which there's been a failure and by enforcement. And I'm an economist. I'm not comfortable being an advocate. But I have to say though we hear from everyone that the rules are being enforced and there's strict enforcement and strict compliance, I don't see anyone who's been sanctioned. I don't know of any case in which there's been a sanction. No one has gone to jail. No one has paid a fine. There are still 130 million, 120 to 130 million fails, existing fails every day just on the listed exchanges and three to 400 million among unlisted stocks, today. And this is -- SHOs been in place for a long time. So it's a -- if we're going to give credence to the claim that these regulations are in fact being strictly enforced in order to protect the integrity of the capital markets, which I believe in, then we need evidence of it. With all the evidence that we have, we cannot believe that there is no one violating it. And yet, no one is sanctioned anywhere. And no one is even reprimanded publicly. So where is the enforcement? I would like to see greater evidence. And the way that we can, the only way that we can track whether or not these are self-regulating organizations which have enormous ability and power to regulate themselves in the interest of the entire American economy, the only way that we can tell whether in fact anything is being enforced and anything is being complied is if all the data are publicly available.

Ralph: Okay, thank you. Dr. Trimbath?

Trimbath: So on the question of how to end fails, I don't work for a regulator and I've been away from the depository for a while now. So I think I'll take a stand that will sound a lot like what you've already heard but maybe in fewer words. I hope in fewer words. I just would say that there is no such thing as an innocent fail. As Anand said, it is bad business practice to fail. And therefore, dissimilar to overdraft fees and bounced checks, from what we've heard today, the magnitude of the problem is such that maybe what we need is penalties and busted trades in order to give the incentive to people for good behavior.

Ralph: Okay, I'm going to take the liberty of speaking as the Securities Regulator for the State of Connecticut, nothing to do within NASAA. Okay? I'll make three observations for myself from my own state perspective. One is the NASD proposed rules dealing with the announcing on the short selling. I think that if you can even do that on a greater basis of greater frequency than the twice a month, that would be great. And instead of doing a snapshot picture, it might be better if you give the average short sale volume as opposed to what they call the snapshot picture of what it'll look like on one day. So that's something, if you guys would consider, that would be great.

Another comment I will make is directed towards my colleagues at the Commission is to the extent that it's possible when reviewing Reg SHO to eliminate the grandfather, that would be something I think that will go a long way to resolving the issues. And I appreciate the fact that eliminating them may cause some volatility, but to the extent that you might want to start phasing out the grandfathering by saying all those shares that were failed greater than twelve months must be settled within 30 days; all those between 9 months and 12 months can be settled, must be settled within another timeframe. You won't get the disruption of the volatility in the market, but what you will do is ultimately resolve this issue which has caused many, many people to question what we've done as governance.

So I offer that and the third thing I would say is to those of you in the room that have the ability to raise the question about the voting rights and the fact that we don't have the same amount of voting rights that I thought I did when I started this panel, I think that needs to be looked at and explored. Those are mine as the State of Connecticut. Do not attribute that to the association I belong to, so that there's no issues about this.

If you guys want to stay a minute or two, there's a couple of direct questions the audience sat through for more than two hours. If we can answer one or two very short, let's do it. If not, hey… One I'll do is Professor Leslie Boni, why isn't she on the panel? Her schedule couldn't permit her to attend. She was asked. Scheduling-wise she had to be back. She would have been on a midnight flight last night and a midnight flight tonight. So to the professor we do appreciate and read her work. And I absolutely look forward to someday meeting her.

Other than taking delivery of certificates, what protects shareholders from phantom shares? Anybody want to take it?

Trimbath: Nothing.

Ralph: Nothing?

Trimbath: Nothing.

Ralph: Okay, solved that one. There was another one about a company. How can a company remove itself from a foreign listing?

Male: You can go and have a negotiation with the German authorities _____I don't think you will be very successful.

Male: Right. You can ask but the reality is, is you can trade stocks anywhere, anytime. I mean we can trade stocks in this room if we wanted to. Anybody anywhere in the world can trade stocks. So just because an exchange lists a stock doesn't mean any trading activity happens there, but you can't stop them from claiming to trade the stock either.

Ralph: Okay, how can company CEOs find out what the amount of fails are in their particular security? Is there a way that they can find that out?

Trimbath: Well, I don't know if there is, but I think that there should be. I mean someone certainly has to know where the fails are, who failed what day because if that information isn't available somewhere, then I think we have bigger problems than we ever imagined. Should that be available to the issuer? I don't see why it wouldn't be. I mean because you're talking about numbers -- you didn't say what broker failed for how many shares on what day, which could be considered proprietary information. You wouldn't -- Macy's doesn't tell Gimbel's, so you don't want Shearson to find out what Merrill did. But for the issuer to know in the aggregate, I don't see a reason why they shouldn't be able to get that.

Ralph: So they should go to the -- what is it, NSCC or is it…?

Male: The DTCC has the data and will not -- and as a matter of policy will not release it to the companies.

Ralph: Well I think that the companies need to make a little noise about that because transparency is the only way you're going to get something done in these markets.

Male: The only way you could get it would be to sue the DTCC.

Ralph: Well, I'm not going to comment. But what I will say is to thank all of you. There are many more questions we really couldn't get to. We had only two hours. This afforded us an opportunity to discuss the issues. I want to thank each and every one of you and especially our panel. So thank you all.

END