

Senator Ted Kaufman's (D-DE) Senate Floor Remarks on Naked Short Selling - June 25, 2009

Mr. President, I rise again to speak out about problems in the financial markets caused by abusive short selling activities, which includes naked short selling and rumor mongering. It can also include abuse of the credit default market by planting false suggestions that an issuer's survival is in doubt.

My focus today, however, is on the first element-naked short selling.

Let me be clear about my main point: The public believes and the SEC has yet to discount that the effects of abusive naked short selling practices helped cement the demise of Bear Stearns and Lehman Brothers, as well as made it significantly harder for banks to raise critical capital in the throes of the financial crisis.

It is no exaggeration to say that abusive short selling at a critical moment further endangered our financial system and economy and thereby helped lead to taxpayer bailouts that have totaled hundreds of billions of dollars.

We are still waiting for the SEC's enforcement response. It's likely that we will continue to wait - as I will discuss - because current rules are ineffective and unenforceable.

There is still a critical need for better SEC regulations that would help the Enforcement Division to do its job and stop naked short selling that is abusive and manipulative dead in its tracks.

Yes, the SEC in April proposed five versions of a return to the uptick rule, which I believe never should have been repealed in the first place, at least without putting something effective in its place.

The uptick rule, which simply required stock traders to wait for an uptick in price before continuing to sell a stock short, was in effect for 70 years until it was repealed in June 2007.

The comment period for the reinstatement of some form of the prior uptick rule is complete, and it's disappointing but not surprising to see that many on Wall Street now oppose that modest step. I continue to urge the SEC to move forward on that front.

As I have consistently maintained in my communications with the SEC, however, reinstating some form of the "uptick" rule alone puts too narrow a frame on the problems associated with naked short selling.

The problem at its root is that the current rules against naked short selling are both inadequate and impossible to enforce. A strict pre-borrow requirement would address the

problem and end it once and for all. Yet the SEC still has done nothing to propose a pre-borrow rule.

If we end up with no uptick rule and no pre-borrow requirement, the SEC will be bending to the will of an industry that has shown recklessness but lacks remorse. There is a fierce urgency to fix this problem now.

Today, the financial markets are teetering on the brink of either continuing with a bull market rally or falling back substantially in what would be the continuation of a severely painful bear market.

If the markets or certain stocks fall back precipitously again, and if bear market raiders act again using abusive naked short selling practices to damage and possibly destroy the stocks of banks and other companies, the SEC will have a lot of explaining to do -- unless we see responses from the agency in the near term.

I have been writing the SEC and talking about this issue on the Senate floor since March 3rd. It is now June 24th and the SEC still has done nothing.

It is time for the SEC to act.

Let me review the history of this issue and the evidence.

Naked short selling occurs when a trader sells a financial instrument short without first borrowing it or even ensuring it can be borrowed.

This converts our securities and capital markets into nothing more than gambling casinos, since the naked seller purports to sell something he doesn't own, and may never own, in the expectation that prices of the instruments sold will decline before ever settling the trade.

Because this activity requires no capital outlay, it also inspires naked short sellers to flood the market with false rumors, to make the prediction a self-fulfilling one.

This practice often leads to fails to deliver. If the seller does not borrow the security in time to make delivery to the buyer within the standard three day settlement period, the seller "fails to deliver."

Sometimes, fails to deliver can be caused by human or mechanical errors, but those types of fails are only a small portion of the actual number of fails to deliver our markets confront continually.

Selling what you don't own and haven't borrowed gives a "seller" a free ride-it effectively says "show me the money" now and you'll get your stock sometime in the future.

By analogy, it's very much like giving access to the Super Bowl on the day of the game, in return for a promise that the spectator will ultimately produce a ticket, long after the big event has occurred.

It's well known that abusive short selling has been linked to the downfall of two major financial firms: Bear Stearns and Lehman Brothers.

According to Bloomberg News, "Failed trades correlate with drops in share value, enough to account for 30-70% of the declines in Bear Stearns, Lehman, and other stocks last year."

The huge increase in naked short selling exacerbated the financial crisis.

In January 2007, 550 million shares failed to deliver. By January 2008, 1.1 billion shares failed to deliver, and in July 2008, over 2 billion shares failed to deliver.

These fails to deliver drove stock value down further than the market would have done by diluting stocks' prices.

According to Clinton Undersecretary of Commerce Robert Shapiro in his recent comprehensive study, "Before Bear Stearns collapsed, its fails to deliver went from less than 100,000 to 14 million, significantly diluting the value of its stock."

As the Coalition Against Market Manipulation stated, "just as counterfeit currency dilutes and destroys value, these phantom shares deflate share prices by flooding the market with false supply."

For example, according to EuroMoney, on March 14th 2008, "128% of Bear Stearns' outstanding stock was traded."

Let me repeat: On March 14th, 2008, 128% of Bear Stearns' outstanding stock was traded.

How can more than 100% of a stock's shares be traded?

It can only occur because of the absence of required borrows and naked short selling.

Without a pre-borrow requirement, in one day multiple locates allow the same single share of a stock to be sold over and over again.

And without effective rules or enforcement, millions of shares are sold short and not delivered as required.

Lehman Brothers also faced a similar abnormal increase in fails to deliver before its collapse.

According to Bloomberg, "As Lehman Brothers struggled to survive last year, as many as 32.8

million shares in the company were sold and not delivered to buyers on time.... That was more than a 57-fold increase over the prior year's peak of 567,518 failed trades..."

Many banks that help drive the U.S. economy are particularly at risk from abusive short selling practices, due to the importance of investor confidence in maintaining their capital.

On September 19th, 2008, the SEC implemented a temporary emergency order barring all short selling, to protect 799 financial companies, which included many banks, because of the damage naked short selling had done in destroying their company and investor values.

But barring all short selling is like throwing the baby out with the bath water.

Proper short selling provides the marketplace with greater liquidity and the prospect of meaningful price discovery.

Naked short selling practices led to market disequilibrium, and the SEC recognized the only way to protect these companies from unnecessary devaluation was to implement a ban.

Many of these companies later moved under the Trouble Assets Relief Program.

While new regulations issued by the SEC last fall were the first steps to protect companies, the SEC has not done enough.

If naked short selling is not policed, and rules against market manipulation are not enforced effectively, naked short selling will continue to harm TARP banks and companies.

If stronger regulations are not implemented, abusive short selling will impair the government's ability to invest taxpayer money into TARP banks and return them to health -- and thus, limit the effects of the government's economic recovery plan.

The SEC began addressing these issues 10 years ago, with a concept release that eventually became what is known today as Regulation SHO, a set of rules that's been amended several times.

But, a price extracted by Regulation SHO was the elimination of the 70 year old "uptick" test.

"Reg SHO" intended to curb naked short selling by requiring would-be short sellers to have merely a reasonable expectation they can deliver the stock when it must be delivered, and imposing a post-trade requirement that would-be short sellers actually pre-borrow securities for future trades only if too many fails have already occurred.

This is somewhat akin to a "one-free-bite-at-the-apple" approach, something regulators attempt to avoid. In practice, it turns out to be a "free-bite-at-the-apple" each time a manipulative trader switches brokers - something a manipulative trader can easily do with no

penalty.

But this rule has proved effectively unenforceable according to former SEC Commissioner Roel Campos and others.

Current SEC regulations allow traders to short a stock if the trader "reasonably believes that it can locate and borrow the security by the settlement day."

Reasonableness includes merely glancing at a list of easy to borrow stocks, with no need to continue to locate even if the list is faulty.

That rule -- the mother of all loopholes -- is much too vague to have any real effect.

Any trader who passed Finance 101 could provide proof that he or she "reasonably believed" the shorted stocks could be located.

In fact, the provision of a false locate is beneficial for generating commissions on the trade.

Ultimately, many commentators and I believe the SEC cannot bring cases against the gravest violators of this rule, because it does not have the means to prove intent.

The rule is in effect unenforceable - and the SEC has in fact not brought a single enforcement case for naked short selling. We must change the rules so the SEC's Enforcement Division can do its job.

Even former SEC Chairman Christopher Cox said the SEC is "concerned that the persistent failures to deliver in the market for some securities may be due to loopholes in Regulation SHO."

It is too difficult to prove a trader's motives necessary for proving a fraud violation.

I strongly believe the SEC needs to strengthen its rules, surveillance, and enforcement regarding naked short selling to prevent market manipulation and loss of investor confidence.

According to Shapiro, "there is considerable evidence that market manipulation through the use of naked short sales has been much more common than almost anyone has suspected, and certainly more widespread than most investors believe."

Furthermore, indicators the SEC typically uses to determine the effects of abusive short selling do not accurately reflect the extent of the problem.

The so-called Threshold List provided by the SEC tracks sustained fails to deliver of over 10,000 shares, accounting for at least 0.5% of a company's outstanding shares.

According to Shapiro, this list does not capture the naked short sales that occur frequently that are under this threshold, and it does not capture the large volume of short interests that can spike during the three day settlement period.

Nor does it capture any trades that occur outside of the Depository Trust and Clearing Corporation, so-called ex-clearing trades.

Other countries have taken proper steps to make sure rules that prevent naked short selling are clear and easy to enforce.

According to EuroMoney, naked short selling is "a situation specific to the US markets....Alan Cameron, head of clearing, settlement and custody client solutions at BNP Paribas Securities Services in London, says he has seen little to indicate similar instances of fails to deliver in Europe. Some European countries like Spain impose strict fines on failures to deliver....It's not an issue here in Europe."

Therefore, I strongly believe the SEC must adopt new policies in order to protect the damage to investor confidence and yes the damage to our economic recovery that is being caused by naked short selling.

Today - along with Senators Isakson and Tester and Representative Carolyn Maloney, who co-chairs the Joint Economic Committee, I wrote to SEC Chairman Mary Schapiro on this subject.

Our letter urged that the Commission establish a pilot program to study whether a strict pre-borrow requirement would work effectively to end the problem of naked short selling. Such a pilot program would lead to the collection of data about stock lending and borrowing and the costs and benefits of imposing a pre-borrow requirement on all short sales.

Recently, Senators Levin, Grassley, and Specter - in connection with the release of a General Accountability Office study analyzing recent SEC actions to curb abusive short selling - called for the SEC to consider imposing a strict pre-borrow requirement on short sales as the best way of ending abusive short selling.

I strongly agree. As I have said, a pre-borrow requirement would address the problem at its most fundamental level and should be urgently considered by the SEC as it rethinks its regulations and enforcement approach in this area.

Moreover, the systems by which stocks currently are loaned and borrowed can - and should - be greatly improved, improving efficiency and producing cost savings.

For example, centralized systems for loaning and borrowing stocks might better enable the SEC to impose fair rules on stock loans and borrows in connection with short sales as well as enhance the SEC's ability to provide regulatory oversight to prevent naked short selling.

As one commentator has written in EuroMoney in December 2008: the "SEC knows it has to introduce the pre-borrow rule if it wants to eliminate fails to deliver for good. As long as there are companies on the Regulation SHO list, then the problem has not been solved...The only sustainable solution to naked short-selling is a rule requiring both a pre-borrow and a hard delivery. ...for Bear Stearns: only a pre-borrow could have put a brake on the naked short-selling."

I urge the SEC to invite a balanced group of commentators, including members of the investing public, to air these issues publicly as it continues efforts to draft and promulgate additional rules to end abusive short selling.

I know that there are critics of a pre-borrow requirement who claim that it would limit liquidity. This isn't so, and there is no meaningful statistical evidence to support this argument. Indeed, the recent study by Robert Shapiro study disproves the claim.

And other knowledgeable sources, like Harvey Pitt - former SEC Chairman and founder of LendEQS, an electronic stock loan transaction forum - believe the opposite would occur, because lending would increase.

In Hong Kong, the imposition of a pre-borrow requirement has been quite successful.

Hong Kong implemented the pre-borrow rule after the Asian financial crisis of 1997-98, when its markets collapsed.

In late 2008, while the U.S. saw an exponential increase in fails to deliver, Hong Kong avoided large spikes in short sales, almost completely.

Other countries, like Australia and many other EU members, have also successfully maintained pre-borrow requirements for years.

The United States must urgently address the issue of abusive short selling. If we want to protect our markets, investors, and companies from caustic manipulation, we need better rules.

In closing, I urge the SEC to act decisively, both by following through and reimposing the substance of the prior uptick rule and through a pilot program to study the effects of a strict pre-borrow requirement.

It is past time to put an end to naked short selling, once and for all.