

Chairman Cox:

As the staff are coming to the table, we'll begin on the next item on our agenda, which is a recommendation from the Division of Trading and Markets.

This recommendation, if we adopt it today, will put in place a new anti-fraud rule specifically aimed at the abusive and manipulative practice called naked short selling. A half century ago, securities trading required legions of messengers, who scurried about lower Manhattan with parcels filled with stock certificates and checks.

And in those days, the New York Stock Exchange would have to close for part of each week to catch up with the paperwork. Today paper's been largely replaced with electronic data, and that's a very good thing.

It's allowed trading volume on the nation's securities exchanges to rise exponentially, and it's helped to drive down the cost of trading for individual investors to a small fraction of what they had to pay in the old days.

But it's also given rise to new opportunities for fraud. In particular, today's elaborate system of electronic net settlement has enabled a particularly pernicious form of fraud called naked short selling.

In a garden variety short sale, the operation of the market is a powerful discipline on the short seller because he or she can experience unlimited losses if the stock's price rises, but that potential for loss, and hence the discipline that the market exerts on short sellers, disappears if the short seller doesn't cover the sale as required.

Legal short sellers have to borrow the shares that they sell. Illegal naked short sellers don't bother with that part. They sell shares of stock that they haven't borrowed, and that they have no intention of borrowing. In some cases, they sell shares that don't even exist.

Illegal naked short selling is an especially serious threat to smaller public companies, whose relatively thin market capitalizations can be more easily manipulated. And in the same way, it threatens the savings and investments of many retail investors in these smaller companies.

There are many legitimate reasons that a trade might fail to settle, but the extreme abuses that are reflected in securities being

chronically listed on Reg SHO's Threshold Security List for months and years at a time is ample evidence that there is also fraud in the market that needs to be arrested.

Periodically there are reports that following a legitimate purchase of 100% of the outstanding shares of a microcap company, millions of phantom shares continue to be traded by naked short sellers.

Reg SHO has done a good job of making the data surrounding these issues public and bringing the problems to the attention of companies and investors, as well as to the SEC and our fellow regulators.

But identifying market manipulation isn't enough. Manipulating the price for security is a serious fraud, and the SEC can investigate and punish it. Reg SHO needs teeth, and this recommendation is aimed at providing them.

It should be enough that an illegal naked short seller can break the law a little bit, and then when he breaks it a lot, all that's required is that he has to cover the short, which the law and the seller's contract would have required in any event.

That's particularly true since the manipulative activity in these cases is aimed at driving down a stock's price, which gives the naked short seller the opportunity to cover at an undeservedly low price.

Reg SHO has accomplished a good deal, but our experience has shown that Reg SHO can't be effective without enforcement. The Commission's Office of Investor Education and Advocacy has received more than 400 investor complaints related to short selling of this kind in just the last year.

The Commission continues to hear from business leaders and policy makers on this issue as well because of the injury that this kind of fraud inflicts on investors, on companies, and on our economy.

It's been four years since the Commission adopted Reg SHO. Requiring that short sellers locate securities before selling them short and imposing order marking and closeout requirements was an important step forward, but it was not enough.

We found, for example, that the grandfather exception to Reg SHO created a significant gap in Reg SHO's application. It excepted "fails to deliver" that occurred before Reg SHO's effective date, or before security was added to Reg SHO's Threshold List, and so last year, we closed that loophole.

The Commission also voted last year to repropose an amendment to Reg SHO that would narrow Reg SHO's options market maker exception. The market maker exception applies to fails resulting from short sells made to hedge positions that were created before an underlying was added to Reg SHO's Threshold List.

In this regard, the Commission is currently considering more than 350 comment letters that we've received on the proposed changes to the options market maker exception. The Commission also is carefully analyzing data related to the impact that this exception has on investors and on the markets.

At the same time, the Commission also is in the process of analyzing preliminary data to examine the impact of the elimination of the grandfather exception on the level of "fails to deliver."

While we're speaking of data in this area, I should point out that this past December, the Commission began publishing monthly aggregate "fail to deliver" data on our Web site at www.sec.gov. The Commission is updating this data quarterly. The availability of this information should help inform public debate on this important issue.

Today's proposal to craft a specifically tailored anti-fraud rule to the abusive practice of illegal naked short selling is an important next step in the battle to end behavior that is corrosive, both to the rule of law and the trust that market participants necessarily place in one another.

Abusive naked short selling saps the confidence of investors and issuers who depend upon our markets to value securities in a fair, efficient, and orderly way. I'm happy to report that this type of abusive conduct is already receiving increasing scrutiny from our Division of Enforcement.

Within the past year, the Commission has sued naked short sellers, who were deliberately misrepresenting to broker/dealers that they obtained a legitimate locate source, and that their orders were long.

And we've charged sellers who misrepresented that their sales were long in order to circumvent the provisions of the Commission's Regulation M.

Today's proposal would add to the Commission's enforcement arsenal a new anti-fraud rule, Rule 10b-21, squarely aimed at naked short selling. It would include within its ambit broker/dealers acting for their own accounts.

A person will be found in violation of Rule 10b-21 if they do the following two things: First, deceive a purchaser, broker/dealer, or certain others about their intention or ability to deliver securities in time for settlement; and second, fail to deliver those securities by the settlement date.

Among other things, proposed Rule 10b-21 would target naked short sellers who deceive their broker/dealers about their source of shares that may be borrowed for purposes of complying with Reg SHO's locate requirement.

The proposed rule would also apply to sellers who misrepresent to their broker/dealers that they own the share being sold. Importantly, proposed Rule 10b-21 is firmly grounded in the Commission's anti-fraud authority under Section 10b of the Exchange Act.

That means that a finding of scienter will be required to establish a violation under the rule. That's an important element to note because legitimate short selling offers our markets many benefits in the way of facilitating liquidity, managing risk, and promoting pricing efficiency.

Today's proposal is in no way intended to discourage any of that very healthy market activity. The Commission intends this proposed rule change to provide further detail on the Commission's views regarding the types of abusive conduct in this area that constitutes fraud.

Proposed Rule 10b-21 also would help to streamline the Commission's prosecution of these kinds of abuses. Additionally, this rule would underscore for market participants in this area the continuing importance of having policies and procedures in place to protect themselves and the markets from the irreparable damage that can be caused by fraudsters operating in this area.

Finally, this rule proposal will put market participants on notice that the Commission's Division of Enforcement will remain vigilant in stamping out abuses in this area, and as is the case with all egregious violations of the Federal Securities Laws, the Commission will be prepared to make criminal referrals in this area where appropriate.

I'd like to thank the staff of the Division of Trading and Markets for their commendable work on this matter. Specifically, Director Erik Sirri, Deputy Director Robert Colby, James Brigagliano, Josephine Tao, Tori Crane, Joan Collopy, Christina Adams, and **Todd Frier**.

I'd also like to thank their colleagues in the offices of the General Counsel, Economic Analysis, and Compliance Inspections and Examinations for their contributions and collaborative efforts.

Finally, I'd like to thank the other commissioners and all of our councils for your work and comments on this proposed rule.

I will now turn the floor over to the Director of the Division of Trading and Markets, Erik Sirri, for a more detailed description of this item.

Erik Sirri:

Good morning Chairman Cox and commissioners. The Division of Trading in the market recommends that the Commission propose a rule that would specify that it is unlawful for anyone to submit an order to sell a security if such person deceives certain specified persons regarding its intention or ability to deliver securities on the date that delivery is due and that there is a failure to deliver.

This recommendation is intended to address potentially abusive naked short selling and "fails to deliver." As you mentioned in your opening remarks, Chairman Cox, in a naked short sell, a seller does not borrow or arrange to borrow securities in time to make delivery to the buyer within the standard three-day settlement period.

As a result, seller fails to deliver securities to the buyer when delivery is due. Sellers sometimes intentionally fail to deliver securities to the buyer as part of a scheme to manipulate the price of a security, or possibly to avoid borrowing costs associated with short sells.

Although the majority of trades settle within the standard three-day settlement period, the Commission adopted Reg SHO in 2004, in part to address concerns associated with persistent fails to deliver and potentially abusive naked short selling.

Reg SHO addresses these concerns in part by requiring a broker/dealer prior to affecting a short sell to borrow or locate securities that the broker/dealer reasonably believes can be delivered by the settlement date.

In satisfying this locate requirement, broker/dealers may rely on a customer's assurances that the customer has identified its own source of borrowable securities for a short sell.

We're concerned that some short sellers have been deliberately misrepresenting to broker/dealers that they have obtained a legitimate locate source, or that they own shares as an end run around the locate requirement.

The Commission enforcement actions have contributed to our concerns regarding the extent that sellers might be making misrepresentations about their locate sources and share ownership.

For example, the Commission recently announced a settled enforcement action against a hedge fund advisor, its chief executive officer, and two employees in connection with improperly marking long certain orders and misrepresenting those to executing brokers that the hedge fund advisor's personnel had located sufficient stock to borrow for short sell orders.

In another settled enforcement action, a broker/dealer's customers allegedly mismarked short sell orders as long after knowing that they could not deliver securities in time for settlement.

The proposed rule that we're recommending today would continue the Commission's efforts at targeting fails to deliver and abusive naked short selling by specifying that abusive naked short selling is a fraud.

Pursuant to the proposed rule, broker/dealers, including market makers acting for their own accounts, would be considered sellers. The rule we are proposing for your consideration would help protect and enhance the operation, integrity, and stability of markets in the clearance and settlement system.

It would also take direct aim at an activity that may create fails to deliver. The Commission and the Division staff have been working to focus short-sell regulation to reduce fails to deliver.

The elimination of the grandfather exception to Reg SHO's closeout requirements became effective October of last year, and the one-time, 35-day phase-in period for that rule amendment ended on December 5th of last year.

The staff has been closely monitoring the impact of the elimination of that exception on failures to deliver. Preliminary results indicate that failures to deliver have not been significantly reduced. The staff believes that the proposed rule we recommend today is necessary to help further reduce fails to deliver.

In addition, we expect to make recommendations to the Commission this spring regarding the amendments proposed by the Commission that address the options market maker exception to Reg SHO's closeout requirements, which the Commission proposed in order to further reduce delivery failures.

In addition to the Division of Trading and Market staff that you previously thanked, Mr. Chairman, I would also like to recognize Janice Mitnick and David Dimitrious in the office of General Counsel; Stewart Mayhew, Amy Edwards, and Tim McCormick and Chuck Dale in the Office of Economic Analysis for their contributions to this release.

Thank you, and I'd be happy to answer any questions.

Chairman Cox:

Thank you, and thank you in particular for offering some examples of the kind of conduct that would violate the rule. I wonder if you could elaborate on those examples and describe what types of activities specifically would be considered deceptive under the proposed rule?

Erik Sirri:

Well, an example would be if you consummated a short sell and you had never, for example, identified the locate source for those securities.

A second example might be one where you'd identified the locate source, but you might have misrepresented the quantity of sales, or you'd identified the locate source, had the right quantity of securities in place, but never actually contacted that locate source to get the securities.

And finally, there's an example where you indicated you were engaging in a long sell and didn't either own the securities, or you knew that you couldn't possibly deliver those securities in time for the settlement date.

Chairman Cox: I wonder if I could ask the General Counsel, is this rule, crafted as it is under our authority under Section 10b of the Exchange Act, going to in any way affect the ability of a private litigant to bring a private right-of-action for alleged fraud in this area?

General Counsel: Well, Section 10b, as you know, has been interpreted for decades by the courts as carrying an implied private right-of-action. The Exchange Act does not contain a literal provision that grants private parties a right to bring an action for violations of rules promulgated under Section 10b, but the courts have implied it.

So those private rights would apply to actions brought under 10b-5, as we all know, and they would also be available for enforcement of proposed Rule 10b-21 should it be adopted.

Chairman Cox: Separately, I guess this is for Trading and Markets, how would market makers engaged in bona fide market making be treated under the proposed rule?

Erik Sirri: Well, I think the first thing to recognize is that we understand that market makers perform an important function in markets, so we don't want to impair their ability to add liquidity or orderliness to markets.

When a market maker deals in the market, they don't make a representation about their locate for the orders. So a market maker in its regular market making activity is not subject to this requirement.

Chairman Cox: And I think this one would be for General Counsel, again. Are broker/dealers gonna be exposed potentially to aiding and abetting liability under this proposed rule?

General Counsel: Well, I think as a practical matter, the likelihood of aiding and abetting liability for broker/dealers is relatively modest. One should never put to one side the potential ingenuity of clever lawyers, but in order to show aiding and abetting liability, you have first to show that there was a primary violation.

What would be a primary violation of proposed Rule 10b-21? Well, it's if a person submits an order, so we're talking here presumably about a customer, if such person deceives a broker/dealer or some other specified persons that the typical customer will not have contact with.

So a key element to establish the primary violation is that the broker/dealer was deceived. In order to establish an aiding and abetting charge, not only must there be a primary violation and substantial assistance, but the broker/dealer has to know of the violation.

So it is close, maybe not exactly, but close to a contradiction in terms that the broker/dealer would have both been deceived and know about the potential violation.

So I think the realm of aiding and abetting liability here is modest. Broker/dealers, of course, could be primary violators if they in turn deceive other participants in the transaction under the proposed rule.

Chairman Cox: And just staying with broker/dealers for a moment, what would be the likely impact on broker/dealers of this rule taking effect. Would they be motivated or required to modify their procedures to comply with the rule, and do we have a sense as to what that might entail?

Male 1: Mr. Chairman, broker/dealers that are in compliance with SHO should not have to modify their procedures. As the General Counsel pointed out, their exposure under the rule would only occur if they were aiding and abetting.

Nonetheless, we have asked questions in the release in case to probe whether there could be any unintended costs or procedures that would need to be changed.

Chairman Cox: And finally, you mentioned, Erik, that you think that you need this kind of rule in order to crack down on the abuses that we've seen in the enforcement area. Are we prepared to say that we think that this rule will result in a reduction in fails to deliver?

Erik Sirri: That's our hope. We hope that by being this specific, that it will reduce the number of fails to deliver.

Chairman Cox: Well, thank you very much. Not having any further questions, then I would be happy at this point to recognize Commissioner Atkins.

Commissioner Atkins: Well, thank you very much, Mr. Chairman. For many years now, many investors have voiced their concern about the real economic impact of naked short selling, and I've shared their concern.

Our markets certainly are not better because some claim to sell more securities of a company than even exist. That creates the threat of fraud and manipulation. But we all acknowledge that the behavior that the proposed rule addresses is already covered under Rule 10b-5.

The question is, will this rule add anything new to our toolkit to fight fraud and manipulation? To the extent that the proposed rule puts people on notice of prohibited behavior, it may be valuable.

On the other hand, could this rule do more harm than good? Will this rule, by singling out short-selling, make people reluctant to engage in legitimate short selling? Legitimate short selling, after all, is a practice that tempers over exuberance in the marketplace and helps to maintain a less volatile imbalanced market.

So I support putting the rule out for comment. I'm sure that commenters will help us in assessing whether this sort of rule is necessary, and if so, whether we should make modifications to our approach generally, or to specific aspects of the proposed rule.

I have a few questions, first for our economists. How wide spread are fails to deliver?

Female 1: Well, many stocks have fails to deliver, but the dollar value is a small portion of the market. On an average day, trades and threshold securities that fail to settle on T+3 account for less than 1% of the dollar value of trading in all securities on that day.

Commissioner Atkins: Okay, then how might – I guess, you have basically two ways of short selling, one is against the box, and one is essentially naked, but most people, of course, depend on their broker to locate the securities, except for institutional investors like hedge funds and others who might not.

How might this rule influence the behavior of broker/dealers and their customers?

Female 1: Well, we do think that the rule has the potential to change behaviors of broker/dealers and their customers, and we look forward to what commenters have to say on the issue.

Commissioner Atkins: Okay, alright. Well, I don't want to put you on the spot there, I look forward also to the comment.

Yes, sir?

Erik Sirri: I was only gonna add that we know that away locates are about 10 to 20% of shorts, so I think a possible concern is that broker/dealers may, in some sense, be more unwilling to take away locate. If that had the effect of impeding the operation of the shorting, which has an important effect on price formation, then that's something we want to hear from commenters.

Commissioner Atkins: Okay. For the General Counsel I had a couple of questions. What aspects of the rule ensure that it's not used to punish well-intentioned market participants who run into, let's say, unanticipated difficulties that then prevent them from delivering by the due date?

General Counsel: Well, the rule requires that a person deceive a broker/dealer or another participant in the transaction, one of the specified persons. In order to make out a case for deception, the Commission would need to show knowledge, or at least a scienter, that is extreme recklessness.

Courts have formulated that in many different ways. One that is cited perhaps most frequently goes back over 30 years now to the Sundstrand case and the requirement to show recklessness is that the danger be so obvious that the defendant must have been aware of it.

So we're all aware of the litigiousness of our society generally. Nonetheless, the requirements to be shown here are relatively sturdy, I believe, although I also think that in appropriate cases where that can be shown, the claims can be made out, both potentially by the Commission or by private plaintiffs.

Commissioner Atkins: And so if a seller who obtains or locates from a – I guess what turns out to be, say, a disreputable source, and then fails timely to deliver securities, that person then violate the rule?

General Counsel: No, not necessarily. In order to violate the rule, that person would – it would have had to have been so obvious, to use the Sundstrand formulation, to that person that the source would not be able to provide the security, that the defendant must have been aware of it.

So in that circumstance, one would assume there would be no liability, in fact.

Commissioner Atkins: Then when you were talking about private rights of action – I mean, clearly we – the SEC has a standing to sue under those, but with respect to private rights of action, who do you think would have standing under this?

General Counsel: Well, in order to have standing, you would have to show, or at least to make out – let's even look – broaden your question just slightly – for a private plaintiff to make out a case here, the plaintiff would have to show that there had been a violation, there had been a deception, that the plaintiff had relied on that deception in connection with the purchase or sale of a security, that that deception had given rise to loss that the plaintiff suffered, and I guess maybe –

Have I got the whole list there? Maybe I do. And so each of those elements would have to be shown in order for a private plaintiff to be able to make out a case. That's just basic Section 10b law, and in appropriate cases, those could be made out. But the set of all likely plaintiffs is going to be relatively modest in each transaction.

Commissioner Atkins: Okay, and finally, with respect to the complaints that we've received in this area, have we noticed a pattern as far as what's going on out there?

I know in my own experience, before coming to the SEC, there have been instances of, I think, or at least where it seemed like there was a concerted effort to try to send in a lot of calls to prosecutors and to the SEC, and then to work with forces in the marketplace through shorting and whatnot to try to drive down target company stocks, and try to drive them down.

But I was wondering if we've seen anything from these complaints that would indicate activity like that?

General Counsel: Commissioner Atkins, occasionally we hear complaints about what I would call the sort of spreading of supposedly false rumors, but we haven't had a pattern of complaints about naked short selling.

What we have had are instances that both the Chairman and Erik alluded to of cases where a few sellers appear to have engaged in naked short selling by not doing locates and borrowing stock, and some sellers have said that they own stock and haven't owned stock and thus lied about it.

But I don't think we've had enough to say that there is a particular pattern of what kind – a certain activity.

Commissioner Atkins: Okay. Well, I hope through our Enforcement Division that we can go after that sort of activity because it's obviously not good for investors, not good for issuers, and not good for the marketplace.

So if this will help, then I'm all for it, and I look forward to comments that we might receive. Thank you very much.

Chairman Cox: Thank you, and just if I may, a follow-up with the Office of the Chief Economist on the 1% figure. What is 1% of daily trading volume in dollar terms? Ballpark.

Male 2: Well, it's about – I guess most recently it's about one hundred and thirty-six billion per day.

Chairman Cox: Would be 1%?

Male 2: Oh, no, that's total average daily trading volume is a hundred and thirty-six billion per day, so 1% of that is 1.4.

Chairman Cox: So a billion and a third a day?

Male 2: Right, about.

Chairman Cox: Okay. Thanks. Commissioner Casey?

Commissioner Casey: Well, I just have a few comments and a couple of questions. I'd also like to start off by commending the Division of Trading and Markets for their hard work on the proposal before us today.

Second, I believe today's proposal is intended to underscore the importance the Commission continues to place on combating abusive naked short selling and persistent fails to deliver.

It's also a compliment to the Commission's earlier adoption of Reg SHO in 2004, last year's amendments eliminating the grandfather provision, and the reproposal to limit the rule's option market maker exception.

Third, while the conduct targeted under the proposed rule is already prohibited by the general anti-fraud provisions of the Federal Securities Laws, proposed 10b-21 is intended to more clearly target short sellers who deceive others about their intention or ability to deliver securities in time for settlement and that fail to deliver securities by settlement date.

I'd like to note that fourth and finally, which is probably just as important, is that while it's important that what we do is symbolic in part, I think it has to be more than symbolic, and so I'm really looking forward to the comments that we receive on whether the approach that we've taken in this rule is likely to be effective in achieving its stated goals.

I think we've clearly identified in the release many of the benefits that we believe will flow from it, but I think it's also just as important to understand if there are any unintended consequences as well.

So again, I look very much forward to the comments that we receive on the release to ensure that the rule achieves its goals, and that we don't fully appreciate any unintended consequences that might come from it.

Along those lines, I guess I want to just ask a couple of questions: One, the first one is to OGC. I was just wondering if there's any precedent for the Commission proposing rules prohibiting behavior that is already illegal?

General Counsel:

Oh, sure. I think maybe the most famous would be the certifications. Maybe it wasn't exactly the Commission, it might have been the Congress, required under the Sarbanes-Oxley that chief executive officers and chief financial officers prior to the passage of Sarbanes-Oxley were required to assign 10-Ks and 10-Qs and other filings with the Commission.

So they were, to use the popular jargon, "on the hook" for the contents of those documents prior to the passage of Sarbanes-Oxley. Sarbanes-Oxley required that they give

certifications that were in many respects merely restatements of what they were already responsible for.

I think we have witnessed the practical effect that those certifications had. The specificity of them resulted, I think most people believe, in a greater degree of care and attention being paid by the officials affected.

So I think it's relatively common in the law for there to be general proscriptions and very specific targeted proscriptions that might fall within the ambit of the more general; and, in fact, it affects conduct. So this is something that has lots of precedent.

Commissioner Casey: I appreciate that. Sort of as a follow-on to that, in our Reg-Flex Analysis in the release, we note that the Commission believes that there are no federal rules that duplicate, overlap, or conflict with the proposed rule.

So I guess, just sort of discussing the – perhaps the overlap or duplicate how we can address that. Could you just answer how we make that conclusion? It's on Page 31.

General Counsel: Is it –

Commissioner Casey: Either one.

General Counsel: I was waiting for the Division to answer, so that's why there was a pause.

Female 2: We'll take a look at it to make sure that that's accurate, just to make sure, and we'll talk to OEA and GC in making sure we've got that accurate.

Commissioner Casey: Okay. I appreciate that.

And then I note that we've put out many questions again for comment, one of which I guess I'd be curious to hear whether we have any perspective on at this point, which is whether or not we would anticipate that the proposed rule would induce short sellers to execute trades in overseas markets?

Erik Sirri: I'm not sure we have a – I don't think that's a result that we would anticipate. There might be a mechanism that would cause that to happen, but it's certainly not come up in our dialogue, in our discussions with people.

I think it's a good example of something that might come up in the comment period, and we'd pay attention to that, but I'm not aware of any discussion about that.

Commissioner Casey: Mr. Chairman, I have no additional questions. Thank you very much.

Chairman Cox: And thanks once again to the staff for excellent work in bringing this proposal forward. The question is now on approving the recommendation, and I would note for the record that the version of the proposing release that we are voting on is the version that was distributed to Commissioners yesterday.

Does the Commission vote to publish for public comment proposed Rule 10b-21?

Commissioner Atkins: Aye.

Commissioner Casey: Yes.

Chairman Cox: Yes, and the recommendation is approved.

The third item on our agenda today is a joint recommendation from the Division of Trading and Markets and the Division of Investment Management, so we'll take just a moment while the new staff takes their place.

The purpose of this next proposal is to protect investors privacy when it comes to their most personal financial investment information.

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