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May 20, 2008

Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, NW
Washington, DC 20549

Re: File No. S7-08-08; Release No. 34-57511
Proposed "Naked" Short Selling Anti-Fraud Rule

Dear Ms. Morris:

The Washington Legal Foundation (WLF) hereby submits these comments to the proposed changes by the Securities and Exchange Commission (SEC) to Regulation SHO, the "Naked" Short Selling Anti-Fraud Rule. 73 Fed. Reg. 15376 (March 21, 2008). The proposed Rule 10b-21 would specifically address the abusive practice of "naked" short selling, which is already a violation of the general anti-fraud provisions of the securities laws, including Rule 10b-5.

If adopted, Rule 10b-21 would make it an unlawful manipulative or deceptive practice for any person to submit an order to sell a security if such person deceives a broker-dealer or purchaser regarding the seller's "intention or ability to deliver the security on the date delivery is due, and such person fails to deliver the security on or before the date delivery is due." 73 Fed. Reg. 15385. Unlike normal short selling where the seller borrows the security that is sold, in a "naked" short sale, the seller does not borrow or arrange to borrow the securities in time to make delivery to the buyer in the standard three-day settlement period. In essence, the "naked" short seller is selling counterfeit or phantom securities that harm investors and the company whose stock is being sold short.

While WLF has been critical of short selling, particularly when it is done in conjunction with lawsuits filed by plaintiffs' attorneys against the companies whose stock is being shorted, it is particularly incumbent on the SEC to enforce the securities law already on the books against those who engage in "naked" short selling and fail to deliver the security. Unfortunately, the enforcement track record of the SEC in this area is seriously lacking.

Furthermore, the SEC should require greater transparency in the short selling process by requiring prompt disclosures by the clearing agencies regarding all short sale transactions. In short, the proposed rule, while a step in the right direction, seems to be more window dressing rather than the tough measures necessary to combat this serious fraud and market manipulation. Considering the SEC's track record in combatting abusive short selling, this proposed rule is too little, too late.

Interests of WLF

WLF is submitting these comments as part of its INVESTOR PROTECTION PROGRAM. The goals of WLF's INVESTOR PROTECTION PROGRAM are comprehensive: to protect the stock markets from manipulation; to protect employees, consumers, pensioners, and investors from stock losses caused by abusive litigation practices; to encourage congressional and regulatory oversight of the conduct of the plaintiffs' bar with the securities industry; and to restore investor confidence in the financial markets through regulatory and judicial reform measures. Additional information about WLF's INVESTOR PROTECTION PROGRAM is available on our website at *www.wlf.org*.

WLF has filed comments with the SEC that are matters of public interest. For example, on January 26, 2006, WLF filed comments on SEC Release No. 53025 (Dec. 27, 2005) regarding the distribution of moneys placed into seven Fair Funds as a result of a settlement by the SEC with seven New York Stock Exchange specialist firms. On April 30, 2003, WLF filed comments with the SEC in response to request for public comments on the two-day Hedge Fund Roundtable. WLF also filed comments with the SEC on February 26, 2007 in File No. S7-24-06: Management's Report on Internal Control Over Financial Reporting, 71 Fed. Reg. 77635 (Dec. 27, 2006).

WLF also litigates and appears as *amicus curiae* before federal courts in cases involving securities litigation. *See, e.g.*, *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336 (2005); *Merrill Lynch v. Dabit*, 126 S. Ct. 1503 (2006). WLF has also filed a brief in *Free Enterprise Fund v. The Public Company Accounting Oversight Board*, No. 07-5127 (D.C. Cir.), arguing that the PCAOB is unconstitutional because the law prevents the President from removing board members. WLF's Legal Studies Division has produced and distributed timely publications on securities regulations. WLF's recently published Legal Backgrounders on the topic include: Bob Merritt, *The Sarbanes-Oxley Act: A Personal View* (WLF Legal Opinion Letter, Oct. 21, 2005); Peter L. Welsh, *Sarbanes-Oxley And The Cost Of Criminalization* (WLF Legal Backgrounder, Aug. 30, 2002); Robert A. McTamaney, *The Sarbanes-Oxley Act Of 2002: Will It Prevent Future "Enrons"?* (WLF Legal Backgrounder, Aug. 9, 2002).

More importantly, with respect to short selling, WLF has filed several complaints with

the SEC requesting formal investigation of several instances where there appeared to be a manipulation of the price of the stock by short sellers who were collaborating with class action and plaintiffs' attorneys.

For example, on January 21, 2003, WLF filed a complaint with the SEC calling on the Commission to conduct to formal investigation into the short-selling of J.C. Penney Co. stock that occurred shortly before and after a major class action lawsuit was filed against Eckerd Drug Stores, which was owned by J.C. Penney. As more fully described in that complaint, serious questions were raised about the selective disclosure of the timing of the lawsuit to short-sellers of J.C. Penney Co. stock as reported in a *Wall Street Journal* article of January 7, 2003, *Suit Batters Penney Shares, But Serves Short-Sellers Well*. Unfortunately, it does not appear that the SEC took any action in that case.

On December 19, 2003, WLF filed a complaint with the SEC, as well as with the U.S. Department of Justice, the U.S. Attorney's Office in San Francisco, California and with then-Attorney General Eliot Spitzer, requesting an investigation into whether any federal civil or criminal laws were violated with respect to short selling of the stock of Terayon Communication Systems, Inc. (Terayon), and related conduct in a class action securities fraud lawsuit against the company filed by Milberg Weiss Bershad Hynes & Lerach. *In re Terayon Communication Systems, Inc. Securities Litigation*. While it appears that the SEC did some initial investigation into this matter, no enforcement action was taken.

On July 13, 2004, WLF filed a complaint with the SEC requesting that it conduct a full and thorough investigation of the facts and circumstances regarding the lawfulness of certain communications by a plaintiff's attorney designed to depress the stock price of Bayer AG, a German company that is traded on the New York Stock Exchange. The goal of the attorney was to pressure the company to settle the product liability lawsuits against Bayer over its cholesterol drug Baycol. Mikal Watts, a noted plaintiff's attorney, boasted to the *Wall Street Journal* in a May 3, 2004 article that in order to pressure Bayer to settle his questionable product liability lawsuit seeking $550 million, he was disseminating negative information about Bayer to the media to engender damaging stories, which in turn would drive down the price of Bayer stock: "I was feeding a lot of [negative] information to European and U.S. papers . . . . It was part of my strategy to affect the stock price, which I was very successful at." As with the J.C. Penney complaint WLF filed in 2003, no action was apparently taken by the SEC on this complaint.

On May 22, 2003, WLF also testified before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services of the U.S. House of Representatives on "The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk: The Relationship Between Short Sellers and Trial Attorneys."

Thus, WLF has been very active in trying to combat the abusive practices of short selling; however, the SEC has been woefully remiss in its duties to enforce the law.

Comments on Proposed Rule 10b-21

As noted, the proposed rule would make it an unlawful manipulative or deceptive practice for any person to submit an order to sell a security if such person deceives a broker-dealer or purchaser regarding the seller's intention or ability to deliver the security on the date delivery is due, and such person fails to deliver the security on or before the date delivery is due. This "fail to deliver" or FTD of the underlying security is the crux of the problem with "naked" short sellers.

The immediate impact on those who "bought" these phantom or counterfeit shares from "naked" short sellers is that they are, in effect, involuntarily loaning the stock to the short seller. In such a case, they also are deprived of voting rights that otherwise would be theirs if they possessed the stock, and may even suffer differing tax treatment of substitute dividends.

As noted, this form of market manipulation is already illegal under other provisions of the securities law. What has been lacking is effective enforcement by the SEC in this area. As stated in the comments filed by the International Association of Small Broker Dealers and Advisors (IASBDA), this proposed anti-fraud rule "adds nothing to [the SEC's] arsenal" and simply "delays the Commission in implementing a truly effective rule because of the waste of resources in rulemaking for authority the staff already has." As the IASBDA notes, the current rules allow a short seller only to locate the stock among various lenders without requiring a contractual agreement to borrow (pre-borrow) the security. WLF agrees with IASBDA that there should be an effective locate requirement and that the SEC should target both sellers and lenders who fail to provide the shares to the short sellers.

WLF recognizes, however, that there may be practical difficulties in requiring a hard locate or pre-borrow rule. As Professor James J. Angel of Georgetown University explained in his comments, there very well may be situations where orders are not executed and thus, there would be no need to pre-borrow the security. Indeed, the wording of the rule may be overbroad and ensnare those who buy and sell a stock long, and where there may be legitimate reasons why the stock was unable to be delivered in the normal three-day period. Instead, there may be other measures that the SEC could take to deter FTDs. One suggestion that WLF believes is worth considering is to impose a cost on those who fail to timely deliver the shorted stock. As Professor Angel suggests, the SEC may consider charging late fees for FTDs, or, in the alternative, give the buyers the option to bust the failed trade if it does not settle within the normal three-day period.

As it now stands, there are several hundred stocks on the so-called Threshold List, many of which have been there for over 100 days, despite the normal three-day rule for settlement of the transaction. As long as the SEC fails to take appropriate enforcement action against such manipulators, the new rule will more likely drive up transaction costs for honest traders, while violators will continue their illegal practice.

The comments submitted by BioTech Medics, Inc. discusses several examples of repeat offenders who operate with impunity because of SEC's lax or delayed enforcement efforts. For example, in the case of CMKM Diamonds, it took the SEC well over five years to bring an action on April 7, 2008 in federal court in Nevada against a major manipulator of that company's stock involving fraud of over $100 million. Furthermore, offshore non-NASDAQ brokerage firms are not required to report short selling.

Many of the abusive "naked" short selling activities occur with smaller companies or so-called "penny stocks" where there are many opportunities for "pump and dump" schemes. Accordingly, the SEC should consider a ban on shorting stocks altogether in these categories of stock as suggested by BioTech Medics, Inc. It is clear, however, that the short selling abuses are not limited to these smaller microcap companies, but also affect larger companies as well. FTDs have affected Overstock.com, which filed suit against the short sellers in 2005, Martha Stewart Omnimedia, and Netflix.

In addition to taking strong enforcement action against abusive short sellers under current law, the SEC should, at a minimum, require transparency so that investors and the company whose shares are being sold short will have timely information on the particulars of the short selling. Thus, the SEC should require the clearing agencies to publicly disseminate on their websites daily information regarding the identity of the short sellers and the number of shares that are sold short, as well as those that have failed to deliver for each security, as further suggested by Professor Angel in his comments.

Conclusion

For the foregoing reasons, the SEC should vigorously enforce existing law against abusive short selling and "naked" short selling. If the SEC decides to go forward with this rulemaking, it should toughen the rule as suggested by WLF and various commenters, and reissue the proposed rule for another round of public comment.

Respectfully submitted,

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