



NASAA

January 5, 2004

Jonathan Katz, Secretary
U.S. Securities and Exchange Commission
450 5th Street NW
Washington, DC 20005

Via e-mail to: rule-comments@sec.gov

**RE: SEC Release No: 34-48709, File No. S7-23-03
Short Sales: Proposed Rule**

Dear Mr. Katz:

Please accept the following comments from the North American Securities Administrators Association (NASAA)¹ regarding Release No: 34-48709: "Short Sales: Proposed Rule." The Commission approved seeking comment on the proposal for a new Regulation SHO, as well as amendments to Rule 105 of Regulation M, on October 29, 2003. The proposal was published in the Federal Register on November 6, 2003 (Vol. 68, No. 215, 62972).

NASAA commends the Commission for its initiative in this area. From the time the so-called "naked short selling" controversy was initially identified in early 2003 by national commentators, a NASAA Project Group has monitored this issue from the perspective of its impact on small-business issuers, the securities of which are traded in the over-the-counter market, as well as their public stockholders, who have contended that the trading market for their shares has been adversely affected by manipulative short selling activity. While the issue involves national trading markets such as the Over-the-Counter Bulletin Board and the Pink Sheets, every state has small-business issuers whose securities trade in the over-the-counter marketplace, as well as public investors holding the securities of those issuers. NASAA thus regards it as critical that the existing rules in place nationally to govern short selling be revised to effectively remedy potential trading abuses.

The Commission's rulemaking proposal is extensive. It includes not only specific rules to deal on a near-term basis with certain aspects of the short selling issue, but also poses numerous questions on various technical aspects of short selling, suggesting that additional Commission rulemaking is envisioned. NASAA will take this opportunity to provide comments on specific aspects of the Commission's proposal.

¹ The oldest international organization devoted to investor protection, the North American Securities Administrators, Inc. was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

Uniform Locate and Delivery Rule

The essence of naked short selling is selling short without borrowing the necessary securities to make delivery, potentially resulting in a “fail to deliver” securities to the buyer. NASAA acknowledges the importance of the aspect of the Commission's proposal that requires short sellers to locate the securities they will be borrowing before they proceed with the short sales. There have been well-publicized instances of unethical individuals and firms shorting a stock without having identified adequate shares to borrow, then maliciously working to drive down the price of the underlying stock.

The Commission's proposal contains a uniform standard in Proposed Rule 203 that specifies procedures for short sellers to locate securities for borrowing. Under Rule 203, a broker-dealer would be prohibited from executing a short sale order unless the broker-dealer, or the person for whose account the short sale is executed, either: (i) borrowed the security or entered into an arrangement for the borrowing the security; or (ii) had reasonable grounds to believe that it could borrow the security so as to be able to deliver the security on the settlement date. Also, and consistent with current self-regulatory organization requirements, proposed Rule 203 would mandate that the “locate” be made and established in writing prior to effecting any short sale, regardless of whether the seller's short position will be closed out by purchasing securities the same day. NASAA concurs that efforts to locate securities to borrow for short sales always should be supported by written documentation.

NASAA also supports the Commission's proposal for a delivery requirement targeted at securities where there is evidence of significant settlement failures. For short sales of any security meeting the current fail-to-deliver threshold in NASD Rule 11830, the selling broker-dealer would have to deliver the securities no later than two days after the settlement date, as opposed to the current 10-day requirement. If such delivery is not made within the two-day period, the seller will be barred from short sales in the particular security for a 90-day period, unless the seller has “pre-borrowed” sufficient securities to deliver against the short sale.

The effectiveness of this “penalty box” sanction/restriction on those who have previously failed to properly settle short sales will obviously have to be evaluated on an ongoing basis. In that regard, NASAA recommends that the restrictions be made tougher – failure to abide by the rules should not only limit broker-dealers or short sellers from executing future short sales in that security, but should limit their ability to execute future short sales in *any* security until such time as the broker-dealer or short seller has implemented a short-sale-delivery compliance plan satisfactory to the Commission. In the interest of meaningful deterrence, the Commission may also want to explore the implementation of certain remedies, such as buy-ins and disgorgement of profits. Violations of the rule in its final form also should provide grounds for conditioning, suspending or revoking the securities licenses of violators.

Further, NASAA is unable to determine why the Commission proposes to permit significant settlement failures at all. While there are instances when settlement may be legitimately delayed, existing regulations provide for extensions for settlement. If the Commission continues to allow settlement failures, it may well facilitate the harm that the proposal is designed to remedy. NASAA urges the Commission to reconsider its stance regarding the role of the Depository Trust and Clearing Corporation (the DTC). As a threshold matter, NASAA believes that the Commission should explicitly prohibit the DTC from lending more shares of a security than it actually holds. The utility of the overall proposed rule would be severely impaired unless the Commission undertakes to implement such a prohibition.

Uniform Price Test

The Commission's proposal includes replacing the so-called "tick test" with proposed Rule 201 that would provide a uniform price test using the "consolidated best bid" as the reference point for permissible short sales. However, the Commission's proposal concedes that such a bid test may not adequately address problems relating to the naked short selling of smaller, less liquid securities. Specifically, because the proposed bid test requires the use of a consolidated best bid, it could not be applied to securities that are not subject to real-time consolidated quotes, with the result that NASDAQ Small Cap, OTCBB and Pink Sheet securities would be excluded from the proposed price test. Consequently, reliance would be on the proposed Uniform Locate and Delivery requirements referenced above to address concerns regarding naked short selling of those less liquid securities

The Commission states that it is not contemplating extending the uniform bid test to the above-mentioned securities "... in part because these markets have not been subject to the rule in the past." NASAA questions why the Commission would not extend the proposed bid test to all securities markets and exchanges. NASAA recognizes the difficulties inherent in monitoring the securities traded on the NASDAQ Small Cap, OTCBB, and Pink Sheets. However, the small business issuers whose securities trade in those markets are those most regularly victimized by naked short selling market-makers and brokers. NASAA hopes that the Commission will explore methodologies to extend the uniform bid test to those markets most affected by naked short selling practices.

Market-Maker Exemption

NASAA also believes that the uniform bid rule should be just that: uniform. To that end, we question whether the rule should be applied to both market-makers and specialists alike. NASAA looks forward to further clarification by the Commission on how this exemption benefits the investing public.

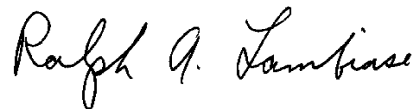
NASAA believes that the blanket exemption for market-makers engaged in "bona fide market-making activity" may need a specific definition. Such definition should explicitly exclude certain naked short-selling-based trading strategies currently implemented by some market-makers, such as the typical "bear raid."

Conclusion

These proposed rules are an appropriate and important exercise of the Commission's rulemaking responsibilities with respect to the national marketplace. It is a welcome step forward in protecting investors and markets. We look forward to continuing to work with the Commission on such matters of mutual interest.

For further information regarding these matters, please do not hesitate to contact either Rex Staples, Senior Enforcement Attorney for the Washington Department of Financial Institutions at (360) 902-8760, and Randall E. Schumann, Legal Counsel for the Wisconsin Division of Securities at (608) 266-1064. John Veator and Mark Davis of NASAA's Legal Department also stand ready to provide any assistance necessary to facilitate the Commission's deliberations.

Sincerely,

A handwritten signature in cursive script that reads "Ralph A. Lambiase".

Ralph A. Lambiase
NASAA President and
Director, Connecticut Division of Securities