S O N E C O N

April 13, 2005

Jill M. Considine
Chairman and Chief Executive Officer
The Depository Trust & Clearing Corporation
55 Water Street
New York, New York 10041-0099

cc: Stuart Z. Goldstein, Managing Director, Corporate Communications
Larry Thompson, Managing Director and Deputy General Counsel

Dear Ms. Considine:

I am Robert J. Shapiro, chairman of Sonecon LLC, a private economic advisory firm in Washington, D.C. I served as U.S. Under Secretary of Commerce for Economic Affairs from 1998 to 2001, Vice President and co-founder of the Progressive Policy Institute from 1989 to 1998, and principal economic advisor to Governor William J. Clinton in the 1991-1992 presidential campaign. I hold a Ph.D. from Harvard University and have been a Fellow of the National Bureau of Economic Research, Harvard University, and the Brookings Institution. I currently provide economic analysis to the law firms of O'Quinn, Laminack and Pirtle, Christian, Smith and Jewell, and Heard, Robins, Cloud, Lubel and Greenwood, on issues associated with naked short sales, including matters raised in an interview published by *@DTCC* with DTCC deputy general counsel Larry Thompson. Certain comments by Mr. Thompson in that interview were inaccurate or misleading, and I request that you allow me to correct the record by publishing this response.

Mr. Thompson begins by asserting that "the extent to which [naked short selling] occurs is in dispute." While this statement may be narrowly correct, objective academic analysis has established that naked short selling has been a widespread practice and one which, when allowed to persist, can pose a threat to the integrity of equity markets. A recent study by Dr. Leslie Boni, then a visiting financial economist at the SEC, analyzed NSCC data and found that on three random days, an average of more than 700 listed stocks had failures-to-deliver of 60 million-to-120 million shares sold short – naked shorts – that had persisted for at least two months.[1] In addition, over 800 unlisted stocks on any day had fails of 120 million-to-180 million shares sold short that also had persisted for at least two months. The total number of naked shorts, including those that had persisted for less than two months, was presumably considerably greater.

Regarding the extent of naked shorts, Mr. Thompson has provided closely-related additional information: "fails to deliver and receive amount to about $6 billion

[1] Leslie Boni, "Strategic Delivery Failures in U.S. Equity Markets," November 2004.

daily…including both new fails and aged fails." Mr. Thompson minimizes this total by comparing it to "just under $400 billion in *trades* (emphasis added) processed daily by NSCC, or about 1.5% of the dollar volume." By most people's standards, a problem involving hundreds of millions of shares valued at $6 billion every day is a very large problem. Moreover, the $6 billion total substantially underestimates the actual value of all failed-to-deliver trades measured when the trades actually occurred. Most of the $6 billion total represents uncovered or naked short sales, many of which have gone undelivered for weeks or months with their market price being marked-to-market every day. As a stock's price falls, the market price of naked shorts in that stock also declines, reducing the total value of the outstanding failures-to-deliver cited by Mr. Thompson.

In other respects, Mr. Thompson's comparison to the "$400 billion in trades processed daily by NSCC" seems disingenuous and misleading, because that $400 billion total covers not only U.S. equity trades which can involve most of the failures-to-deliver at issue, but many other transactions also processed by the NSCC. The value of all equity transactions on U.S. markets in 2004, for example, averaged $82.3 billion/day. If Mr. Thompson is correct that the daily value of fails-to-deliver averages $6 billion, that total is equivalent to 7.2 percent of average daily equity trades or nearly five times the 1.5 percent level suggested by Mr. Thompson. Furthermore, the DTCC reports on its website that on a peak day, "through its Continuous Net Settlement (CNS) system, NSCC eliminated the need to settle 96 percent of total obligations."[2] Assuming that CNS nets out the same proportion of trades on other days, $384 billion of the $400 billion in daily trades cited by Mr. Thompson are netted out, leaving only $16 billion in daily trades that require the actual delivery of securities. The $6 billion of fails-to-deliver securities existing on any day are equivalent to 37.5 percent of the average daily trades that require the delivery of securities, or *25 times* the 1.5 percent level cited by Mr. Thompson.

Mr. Thompson tries to explain the large numbers of shares that go undelivered – in most cases arising from naked short sales -- by citing problems with paper certificates, inevitable human error, and the legitimate operations of market makers. This also seems misleading or disingenuous. Regarding problems with paper certificates, the DTCC estimates that 97 percent of all stock certificates are now kept in electronic form. Nor can human error or legitimate market-making operations explain the high levels of failures-to-deliver that *persist for months* – on any day, an average of 180 million-to-300 million shares have gone undelivered for two months or longer – as documented by Dr. Boni's analysis of NSCC data.

Mr. Thompson also disparages the attorneys who represent companies that have been damaged or destroyed by massive naked short sales, and their shareholders, by claiming falsely that the cases in this matter have almost all been dismissed or withdrawn. The legal firms that I advise -- O'Quinn, Petrie and Laminack; Christian, Smith and Jewell; and Heard, Robins, Cloud, Lubel and Greenwood – have not lost any motions against the DTCC or its affiliates and currently have one case against the DTCC pending in Nevada and another case against the DTCC pending in Arkansas. In addition, on February 24, 2005, these attorneys were granted an order by the New York Supreme Court ordering

[2] www.dtcc.com/AboutUs/weare.html.

the DTCC to produce trading records involving two companies they represent, including records from the Stock Borrow program, which may establish whether large-scale naked short sales were used to manipulate and drive down the stock price of those two companies.

Mr. Thompson also asserts that the plaintiffs suing the DTCC for damages associated with the handling of naked short sales rely on "theories [that] are not an accurate reflection of how the capital market system actually works." This assertion is inaccurate. There is no dispute about how the capital markets work -- nor any doubt that naked short sales have been used to manipulate and drive down the price of stocks, as seen in numerous death-spiral financing cases. The issue here is the DTCC's role in allowing or facilitating such stock manipulation through its treatment of extended naked short sales.

In explaining the DTCC's role in these matters, Mr. Thompson rejects the claim that the NSCC's Stock Borrow program allows the same shares to be lent over and over again, potentially creating more shares than actually exist or "phantom" shares. By Mr. Thompson's own account, shares borrowed by the NSCC to settle naked short sales are deducted from the lending member's DTC account and credited to the DTC account of the member to whom the shares have been sold. Therefore, those same shares become available to be re-borrowed to settle another naked short sale and, if that happens, to be re-borrowed again and again to settle a succession of naked short sales. Throughout this process, the actual short sellers may continue to fail-to-deliver the shares to cover their shorts and, as Dr. Boni's analysis of NSCC data found, the underlying failure can age for months or even years. The process which Mr. Thompson describes is one in which shares *can* be borrowed and lent over and over again, introducing more shares into the market than are legally registered and issued. If any ambiguity remains, Mr. Thompson can clarify it by responding to the following query: Once a share that has been borrowed through the NSCC Stock Borrow program is delivered to the purchaser, is that share restricted in any way so it *cannot* be lent again?

It is important to note that the Stock Borrow program is used when continuous net settlement cannot locate the shares to settle. As a consequence, Stock Borrow is usually called into play when there are relatively few shares available for borrowing. These are propitious conditions for market manipulation: Unscrupulous short sellers undertake large-scale naked short sales involving stocks for which few shares are available for trading and lending, relying on the Stock Borrow program to borrow the limited available shares, again and again, at sufficient levels to drive down the market price of the shares.

Mr. Thompson notes that of approximately $6 billion in outstanding failures-to-deliver existing on any day, "the Stock Borrow program is able to resolve about $1.1 billion … or about 20% [18 percent] of the total fail obligation." In this statement, Mr. Thompson raises very serious questions about the integrity and operations of the NSCC and DTCC, which he can clarify by responding to the following queries: If the Stock Borrow program "resolves" only 18 percent of total fails, what is the disposition of the remaining 82 percent of outstanding fails? When failures-to-deliver occur that are not resolved through Stock Borrow, does the NSCC credit the undelivered shares to the member representing the buyer, creating genuine "phantom shares"? Finally, how many shares do the borrowing brokers, clearing firms and other participants in the Stock Borrow program owe the NSCC on a typical day, and what is their total value?

In a related matter, Mr. Thompson tries to distance the DTCC from charges that shares held in restricted accounts – for example, cash accounts, retirement accounts and many institutional accounts – are improperly lent through the Stock Borrow program by claiming that responsibility for segregating restricted shares from lendable shares falls to the "broker and bank members" of the DTCC, while responsibility for monitoring or regulating their performance in this matter falls to the stock exchanges and the SEC. As a trust company, the DTCC cannot hold that it has no role, duty or responsibility to ensure the probity of its operations. Mr. Thompson could address this issue by responding to the following queries: What procedures does the NSCC have to ensure that shares held in members' accounts for possible loan through the NSCC Stock Borrow program are unencumbered by regulatory or legal restrictions from being pledged or assigned and eligible to be borrowed? On any given day, how many participants in the Stock Borrow program have lent shares that exceed their lendable shares, in what numbers and of what value?

Mr. Thompson also tries to distance the DTCC as far as possible from the naked short selling that generates most of the extended failures-to-deliver: "We don't have any power or legal authority to regulate or stop short selling, naked or otherwise. We also have no power to force member firms to close out or resolve fails to deliver … we don't even see whether a sale is short or not." In fact, the DTCC *chooses* to not distinguish short sales from long sales, *chooses* to not regulate or stop extended naked short sales, and *chooses* to not force member firms to resolve protracted naked short sales.

First, Regulation SHO requires that all transactions be clearly marked short or long. If the DTCC and NSCC do not know whether sales are short or long as Mr. Thompson contends, they *choose* to not know. Second, the NSCC has a clear responsibility and adequate means to stop naked short sales of extended duration, with no legal barrier that would prevent them from so doing. As a trust company with an acknowledged duty to provide investors certainty in the settlement and clearance of equity transactions, the DTCC chose to carry out that duty by assuming the role of counterparty to both sides of every equity transaction, through the operations of the NSCC's CNS system and the Stock Borrow program. By allowing short sellers to fail-to-deliver shares for months or even years, the NSCC clearly fails to provide certainty in settlement to the buyers, sellers and issuers of securities. Since it is widely known that extended naked short sales have been used to manipulate stock prices in cases of death-spiral financing, and the NSCC created the Stock Borrow program to address failures-to-deliver that prominently include naked short sales, the NSCC and DTCC share a responsibility with the SEC and the stock exchanges to protect investors by resolving extended fails.

Third, the DTCC and NSCC have the clear capacity to force member firms to resolve the extended failures-to-deliver of their customers by purchasing shares on the open market and deducting the cost from the member's account. A 2003 study by Dr. Richard Evans and others provides evidence that forced buy-ins by any party occur very rarely.[3] They found that a major options market maker who failed to deliver all or a portion of shares sold in 69,063 transactions in 1998-1999 was bought-in only 86 times or barely one-tenth of 1 percent of the fails. Mr. Thompson can clarify investors' understanding of their operations by responding to the following query: What proportion of shares that are persistent fails-to-deliver, of one month or longer, are ever bought in?

Mr. Thompson acknowledges that the DTCC and NSCC know precisely how many failures-to-deliver exist for each stock and the precise duration of each of these fails. Yet, the DTCC refuses to disclose this information even to the issuer of the stock in question, which Mr. Thompson justifies by citing "NSCC rules" prohibiting such a release of data based on "the obvious reason that the trading data we receive could be used to manipulate the market, as well as reveal trading patterns of individual firms." This response is both disingenuous and revealing. We know now, for the first time, that the DTCC has full knowledge of the extent of protracted, large-scale naked short sales in all particular cases. We also know now that the DTCC has had this information for at least a decade, since Mr. Thompson also notes that "fails, as a percentage of total trading, hasn't changed in the last 10 years." Yet, based on the DTCC's own rules, it allowed these abuses to persist and fester. The DTCC and NSCC can change their rules at any time. Moreover, in this case, those rules are unjustified. Data documenting outstanding short sales in each stock are currently issued publicly, so further data on how many of those short sales are naked would *not* reveal additional information about the trading patterns of individual firms or in any way empower manipulators. In fact, the DTCC could substantially disarm manipulators by both publicly reporting naked short sales in each issue and pledging to force buy-ins of all naked short sales that persist for more than a limited period.

Surely, if large-scale, extended naked short sales have effectively created "phantom" shares, companies have a responsibility to their shareholders and the right to secure this information from the organization which manages the settlement of short sales. At a minimum, the DTCC should respond to requests by issuers for data on extended failures-to-deliver in their own stocks, both in the past and currently, so they can take steps to resist stock manipulators or bring them to account for past manipulation.

Mr. Thompson also claims that the DTCC did not create or manage the Stock Borrow program to serve its own financial interest, insisting that the service generates less than $2 million a year in direct fees to the DTCC and that all DTCC services are priced on a "not for profit" basis that seeks to match revenues with expenses. Without further information, these responses beg the question of whose private financial interest has been served by the Stock Borrow program, especially as the DTCC is owned by the stock markets, clearinghouses, brokerage and banking institutions that use its services. Mr. Thompson and the DTCC can clarify this serious matter by responding to the following queries: Do DTCC participant/owners receive interest or other payments through or from the Stock Borrow program for lending the shares of their customers and, if so, how much

[3] Richard Evans, Christopher Geczy, David Musto, and Adam Reed, "Failure *is* an Option: Impediments to Short Selling and Option Prices," EFA 2003 Annual Conference Paper No. 858, March 2003.

have they received for these activities over the last 10 years? Further, do DTCC participant/owners receive any dividend, interest or other payments or distributions from the DTCC or its subsidiaries?

I appreciate the opportunity to address the important issues raised by Mr. Thompson, and I look forward to your response to this request to publish these comments.

Sincerely,

/signed/

Robert J. Shapiro