MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

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**Via Electronic Mail**: dp09_01@fsa.gov.uk

Mr. Stephen Sie
Market Monitoring
Financial Services Authority
25 The North Colonnade
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London E14 5HS

**Re: Discussion Paper 09/1, Short Selling**

Dear Mr. Sie:

Managed Funds Association ("MFA")[1] welcomes the opportunity to provide comments to the Financial Services Authority ("FSA") in response to Discussion Paper 09/1, Short Selling (the "Discussion Paper"). MFA and its members share the FSA's deep concerns about the crisis in the global financial markets and strongly support efforts to prevent, detect and punish manipulative conduct. During this volatile period, it is important that policy makers adopt measured responses that will enhance market confidence and lead to greater market stability. As described below, we are concerned that a requirement for individual investors to publicly disclose their short positions could instead increase market volatility and preclude investors from performing critical risk management functions.

Our comments to the Discussion Paper follow our previous comments submitted to the FSA in response to its Consultation Paper 09/1, Temporary Short Selling Measures ("Consultation Paper").[2] MFA has also submitted letters to the U.S. Securities and Exchange Commission ("SEC")[3] in response to

[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

[2] Letter from Stuart J. Kaswell, Executive Vice President and General Counsel, Managed Funds Association, to Stephen Sie, Financial Services Authority, dated Jan. 9, 2009, available at: http://www.managedfunds.org/downloads/MFA%20Comments%20to%20FSA%20Short%20Selling%20Measures.pdf ("January Letter").

[3] *See* letters from Stuart J. Kaswell, Executive Vice President and General Counsel, Managed Funds Association, to Florence E. Harmon, Acting Secretary, Securities and Exchange Commission, dated Dec. 15, 2008, available at: http://www.managedfunds.org/downloads/MFA%20Rule%20204T%20Comments.12.15.08.final.pdf and http://www.managedfunds.org/downloads/MFA%20Form%20SH%20Comment%20Letter.12.15.08.pdf.

its adoption of two interim temporary final rules relating to short selling,[4] and the International Organization of Securities Commissions Technical Committee Task Force on short selling ("IOSCO Technical Committee").[5] The financial crisis has affected market participants throughout the world, and it is important that policy makers across different jurisdictions endeavor to reach consensus on their responses to these events. Many MFA members actively trade in U.K. markets and have considerable personnel and resources located in London, and accordingly have a significant stake in the FSA's proposals and the efficient functioning of these markets. We commend the FSA for sharing its views on short selling with other regulators, and we would be pleased to provide comments to any further international initiatives designed to strengthen the world's capital markets.

We recommend that the FSA require brokers or exchanges, rather than individual investors, to report short position information. For the reasons discussed below, MFA believes that such a reporting regime would provide the FSA with more comprehensive short selling information and better enable it to respond to any potential disruption in the securities markets caused by short selling.

In the alternative, we suggest modifications to the disclosure proposals that would provide the FSA with more useful short sale information while mitigating undue burdens to individual investors. Specifically, we recommend that any rules adopted by the FSA, among other things:

- Require that reporting to the FSA be non-public. Public disclosure of information would result in adverse consequences to investors, issuers and other market participants.

- Increase the *de minimis* threshold to 2.0%. Short positions below 2.0% are not significant and investors should not have to report that information. Moreover, limiting disclosure to more significant positions permits a regulator to more accurately assess risks rather than being inundated with data.

- Reduce the frequency of filing from daily to quarterly to reduce reporting costs and technological burdens imposed on investors and to concentrate reporting to statistically more meaningful data.

- Require that reporting of short positions in companies undertaking rights issues be consistent with other short position reporting requirements.

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[4] Amendments to Regulation SHO, SEC Release No. 34-58773 (Oct. 14, 2008), 73 FR 61706 (Oct. 17, 2008) and Disclosure of Short Sales and Short Positions by Institutional Investment Managers, SEC Release No. 34-58785 (Oct. 15, 2008), 73 FR 61678 (Oct. 17, 2008).

[5] *See* letter from Stuart J. Kaswell, Executive Vice President and General Counsel, and John G. Gaine, President Emeritus and Special Counsel, International Affairs, Managed Funds Association, to Christine Kung, Hong Kong Securities and Futures Commission, dated Dec. 23, 2008, available at: http://www.managedfunds.org/downloads/MFA%20Letter%20to%20IOSCO%20Short%20Selling%20Task%20Force.pdf, and letter from Stuart J. Kaswell, Executive Vice President and General Counsel, and John G. Gaine, President Emeritus and Special Counsel, International Affairs, Managed Funds Association, to Greg Tanzer, Secretary General, IOSCO, dated May 4, 2009, available at: http://www.managedfunds.org/downloads/MFA%20Comments%20to%20Short%20Selling%20Consultation%20Report.pdf.

## I. SHORT SELLING BAN

In response to extreme market volatility, on September 18, 2008 the FSA took emergency measures prohibiting the active creation or increase of net short positions in U.K. financial sector companies (the "Ban").[6] The FSA adopted the Ban to prevent market abuse, protect the fundamental integrity and quality of markets, and guard against further instability in the financial sector.[7] Under the terms of the emergency measures, the Ban expired on January 16, 2009, however, the FSA continues to monitor market activity and stands ready to reintroduce the Ban if it deems it necessary without consulting industry participants.[8]

We continue to support the FSA's decision to allow the Ban to expire on January 16, and recommend that the FSA not reintroduce it or any further prohibitions on short selling.[9] As managers of alternative investment vehicles, our members share the FSA's concerns with respect to investor protection and the orderly functioning of markets, however, we believe the Ban is contrary to maintaining open, efficient markets. Capital markets can operate effectively only if investors have confidence in the stability of the "rules of the game" that all market participants are obliged to follow. Imposition of the Ban disrupted investors' prudential risk management hedging strategies, increased market volatility and reduced liquidity.

Short selling, as recognized by the FSA, is "a legitimate investment technique in normal market conditions," and "can enhance the efficiency of the price formation process." In addition, short selling can "enhance liquidity by increasing the number of potential sellers," and increase market efficiency.[10] The IOSCO Technical Committee has similarly affirmed that "short selling plays an important role in the market for a variety of reasons, such as providing more efficient price discovery, mitigating market bubbles, increasing market liquidity, facilitating hedging and other risk management activities."[11] We strongly agree that short selling provides capital markets with necessary liquidity and plays an important role in, among other things, the price discovery process. Markets are more efficient, and securities' prices are more accurate, because investors with capital at risk engage in short selling. We believe the Ban adopted by the FSA, as well as the prohibition on short selling issued by the SEC in September 2008,[12] had the adverse effects of further reducing liquidity and increasing volatility in the capital markets. In this

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[6] FSA statement on short positions in financial stocks (FSA/PN/102/2008), http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/102.shtml.

[7] Consultation Paper, page 5.

[8] *See* Policy Statement 09/1, Temporary Short Selling Measures (January 2009), page 7.

[9] *See* January Letter.

[10] Consultation Paper, page 4.

[11] IOSCO Technical Committee Consultation Report, Regulation of Short Selling (March 2009).

[12] SEC Order Halting Short Selling in Financial Stocks, SEC Release No. 34-58592 (Sept. 18, 2008), 73 FR 55169 (Sept. 24, 2008).

vein, former SEC Chairman Christopher Cox explained that the biggest mistake of his tenure was the SEC's prohibition on short sales of the shares of 799 financial companies.[13]

We appreciate the FSA's inclusion in the Discussion Paper of its review of academic studies of the effects of the Ban and the SEC's short selling prohibition, in addition to its own analysis of the consequences of the prohibitions to the capital markets, including effects to market efficiency and liquidity. As described in Annex 1, studies of the U.K. and U.S. temporary short selling restrictions conclude that affected stocks exhibited both reduced market quality[14] and liquidity[15] during the prohibitions. The FSA's independent analysis found a significant decrease in trading volume for affected stocks and an increase in bid-ask spreads for the stocks as compared to the market as a whole.[16] For example, the Paper notes that in the sixty days following the introduction of the Ban, trading volume for restricted stocks decreased by 31%, and relative bid-ask spreads for the restricted stocks during those sixty days as compared to the sixty days prior to the Ban increased by an average of 205%.[17] Additionally, the Ban was not effective in preventing price declines of the affected stocks.[18] Studies of the markets during this period have confirmed that the price declines of restricted stocks were generally a result of long sales, rather than short sales.[19]

In contrast to the temporary prohibitions adopted in the U.S. and U.K., regulators in Hong Kong and Singapore did not issue similar short selling prohibitions in response to market turmoil. In fact, a recent report issued by the Hong Kong Securities and Futures Commission affirms that short selling improves market efficiency, increases liquidity, and helps price discovery.[20]

In addition to the negative effects on market liquidity and efficiency generally, short selling prohibitions harm the investment strategies of individual investors. Short selling and other techniques, including listed and over-the-counter derivatives trading, are important risk management tools for institutional investors, including MFA members, and essential components of a wide range of *bona fide* cash and derivatives hedging strategies that enable investors to provide liquidity to the financial markets. The Ban precluded investors from establishing a hedging position that resulted in a net short position of U.K. financial companies during a period of significant volatility in the shares of these firms.

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[13] *SEC Chief Defends his Restraint*, Amit R. Paley and David S. Hilzenrath, Page A01, The Washington Post, December 24, 2008. The Ban and the SEC's prohibition were also flawed procedurally, as regulators imposed them without any notice, comment period, or consultation with industry participants.

[14] Boehmer, E., Jones, C. M., Zhang, X., *Shackling Short Sellers: The 2008 Shorting Ban*, 2008a, preliminary draft, www2.gsb.columbia.edu/faculty/cjones/ShortingBan.pdf.

[15] Clifton, M., Snape, M., *The Effect of Short-selling Restrictions on Liquidity: Evidence from the London Stock Exchange*, 2008, report commissioned by the London Stock Exchange.

[16] Annex 2, page 2.

[17] Annex 2, pages 6 and 7.

[18] Annex 2, page 1.

[19] Credit Suisse, *Examining the Wake of the Short Selling Restriction*, Market Commentary, Oct. 13, 2008.

[20] Research Paper No. 44: *How short-selling activity affects liquidity of the Hong Kong stock market*, Hong Kong Securities and Futures Commission, April 17, 2009, available at: http://www.sfc.hk/sfc/doc/EN/research/research/RS%20Paper%2044.pdf.

The FSA asserts in the Discussion Paper that significant benefits of a short selling ban would include the elimination of the potential for market abuse and disorderly markets. It describes market abuse as the use of short selling "abusively to create misleading signals about the real supply, or the correct valuation of a stock," and "in conjunction with scaremongering tactics to push down the price of a stock."[21] Similarly, disorderly markets result from "the use of short selling strategies, possibly in concert with others, to distort and drive down share prices."

MFA strongly support efforts to prevent, detect and punish manipulative conduct. During its consideration of short selling, the FSA should disclose whether it has identified any potential manipulation of securities prices through spreading of false information, instances of manipulative "naked" short selling or other related market abuses as described in the Paper.[22] We also encourage the FSA to investigate whether the Ban was effective in preventing any market manipulation. We believe that regulators have not sufficiently identified the activity that the short selling prohibitions were designed to address, as compared to the material adverse consequences to markets that occurred during the prohibitions.

For these reasons, we agree with the FSA's conclusion that the positive benefits of short selling strongly outweigh any potential negative effects, and urge that the FSA not reintroduce the Ban. Should the FSA nevertheless determine to reintroduce the Ban on a temporary basis due to market events, we urge the FSA to notify and consult with industry participants prior to taking any action in order to minimize market disruption. Imposition of the Ban for a second time without consultation would again create uncertainty among participants and increase volatility in the capital markets.

## II. NAKED SHORT SELLING

As noted in the Discussion Paper, naked short selling can be disruptive to the normal clearing and settlement process and result in delivery and settlement delays, as well as systematic disturbances. MFA believes, however, it is important that any efforts to address "naked" or "abusive" short selling not restrict legitimate short selling, and we strongly agree that any additional prohibitions on "naked" short selling (or requirements for short selling to be covered) would be harmful to market efficiency and should be not be adopted by the FSA.

In considering the implications of naked short selling on capital markets and potential changes to the current regulatory structure, it is important for policy makers to carefully define the meaning of "naked" or "abusive" short selling. Because "naked" short selling is generally not defined in securities laws, its meaning may have different interpretations across jurisdictions. The FSA in the Discussion Paper describes a naked short sale as occurring when "the seller sells shares they do not own, without having set aside any shares to settle the transaction."[23] The SEC, for example, has described "naked" short selling as occurring when "a seller does not borrow or arrange to borrow securities in time to make

[21] Discussion Paper, page 11.

[22] MFA recently submitted a comment letter to a rule proposal by FINRA relating to the spreading of rumors. *See* letter from Stuart J. Kaswell, Executive Vice President, Managed Funds Association, to Marcia E. Asquith, FINRA, dated Dec. 18, 2008, available at: http://www.managedfunds.org/downloads/MFA%20Comments%20FINRA%20R.2030.12.18.08.pdf.

[23] Page 6.

delivery to the buyer within the standard three-day settlement period. As a result, the seller fails to deliver securities to the buyer when delivery is due (known as a ''fail'' or ''fail to deliver'')." In addition, the SEC has identified abusive "naked" short selling as "selling short without having stock available for delivery and intentionally failing to deliver stock within the standard three-day settlement cycle."[24] Although abusive "naked" short selling is prohibited, "naked" short selling (*i.e.*, an unintentional failure to deliver within the standard three-day settlement cycle), is permitted under limited circumstances attributable to *bona fide* market making activities by market makers.[25]

Absent an appropriate exception, MFA as a policy matter does not condone naked short selling where an investor has not confirmed the availability of a stock to borrow (in the U.S. through the Regulation SHO "locate" process, described below), as it may lead the investor to fail to deliver the stock on its settlement date. As explained in the Paper, current short selling regulations in the U.K. require sellers to avoid failing to deliver a security to the buyer. The FSA considers short selling without any intention or reasonable plan to settle the short position to be market abuse, and the London Stock Exchange can instruct members that short sell (including for an underlying client) to source the stock in the market to enable settlement.[26]

MFA members have strong incentives to prevent failures to deliver from occurring. Failures to deliver are disruptive to a fund's trading program because they interfere with a fund's risk management calculation and introduce another layer of uncertainty—the risk of a trade being cancelled by the clearing broker. In addition, a fund is likely to face significant operational difficulties when there is a failure to deliver a security, including a potentially lengthy trade reconciliation process, the task of updating its books and records, the impairment of voting rights, friction with its prime broker and the uncertainty and risk of a costly buy-in. Funds that conduct algorithmic trading strategies may place thousands of orders to buy and sell various stocks. It would be very costly and operationally burdensome for such a fund to reconcile its trades and update its books and records, among other things, if its clearing broker cancels trades, so these firms have a strong incentive to locate the stocks they intend to borrow in advance of any short sale.

The SEC updated the regulations concerning short selling (Regulation SHO)[27] in 2007, and a short review of that system may illustrate the process in place in the U.S. to prevent abusive short sales. Under Reg SHO, a broker-dealer, prior to accepting a short sale order, must "locate" securities available for borrowing. Rule 203(b) of Reg SHO prohibits a broker-dealer from accepting a short sale order in any equity security from another person, or effecting a short sale order for the broker-dealer's own account unless the broker-dealer has: (1) borrowed the security, or entered into an arrangement to borrow

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[24] Amendments to Regulation SHO, SEC Release No. 34-58773 (Oct. 14, 2008), 73 FR 61706 (Oct. 17, 2008). *See also* "Naked" Short Selling Anti-Fraud Rule, SEC Release No. 34-58774 (Oct. 14, 2008), 73 FR 61666 (Oct. 17, 2008). In its request for comments related to short selling, the IOSCO Technical Committee described "naked" short selling as broadly referring to situations where the seller does not own the stock he is selling and has made no provision, [at the point of sale], to borrow or otherwise for delivery of stock to the purchaser by settlement date.

[25] 73 FR at 61715.

[26] Discussion Paper, page 13.

[27] In this letter, we use the terminology that the SEC employs generally and in particular the terms that the SEC uses in its Regulation SHO, 17 CFR §242.200 *et seq*. MFA appreciates that the FSA uses different terminology to describe similar market participants and concepts.

the security; or (2) has reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due.

To comply with Reg SHO, market participants have made significant investments in technology to enhance their operations. Sell-side firms invested in technology to automate the process of inventorying, compiling and sending lists of securities available to borrow throughout the day and sending automated confirmations to the borrowing market participant and clearing broker once it located a security. Buy-side firms invested in technology to receive automated lists from the sell-side, to systematically compare the list of securities available to borrow with the firm's short interest list, to identify hard-to-borrow securities, and to automate their process to locate securities to borrow. For an easy-to-borrow security, many buy-side firms employ an automated trading system that electronically locates and places trade orders. For a hard-to-borrow security, the general practice is for a buy-side firm to manually confirm location of the security before placing the trade order to minimize the likelihood of a failure to deliver the security. Many prime brokers built in the added step of performing daily reconciliations, identifying short sales that they process with respect to whether a locate was performed in advance of the trade. Such practices instill discipline into the trading process and reaffirm the locate process.

In the United States, Reg SHO has benefited investors by providing a regulatory framework that creates greater market stability, market liquidity and investor confidence. Reg SHO created operational efficiencies that contributed to tighter bid-ask spreads and more liquid markets. In developing Reg SHO, the SEC focused on modernizing short sale regulation, in a way that maintains the benefits of short selling while minimizing naked short selling and failures to deliver. The SEC worked with various investor and industry groups to understand the dynamics of short selling and the clearing and settlement process before implementing a uniform standard specifying the procedures for all broker-dealers to locate securities for borrowing.

We believe that the U.S. Reg SHO short selling framework has been highly effective in substantially reducing fails to deliver without disruption to the market.[28] If the FSA were to consider other methods to limit investors engaged in a short sale from failing to deliver a security to the buyer, we urge that any future regulation continue to limit disruption to the market and not interfere with timely and best execution of trades. More specifically, we are supportive of the general framework of Reg SHO, and believe appropriate regulatory controls for short selling include:[29]

- A requirement for broker-dealers to "locate" available shares of a security before engaging in a short sale;
- A requirement for broker-dealers to mark trade orders long or short;
- A requirement for executing brokers to confirm to customers that they located securities sold short prior to their sale;
- A requirement that exchanges or similar registered market centers publish a "threshold" security list—a daily list identifying securities subject to persistent failures to deliver; and
- A close-out requirement with a reasonable time period that minimizes any market disruption.

[28] *See* Regulation SHO Proposed Amendments, Exchange Act Release No. 54154 (July 14, 2006), 71 FR 41710 (July 21, 2006).

[29] MFA believes that such requirements should apply in the first instance to broker-dealers (or clearing agency participants), and that customers of broker-dealers should be subject to such requirements only indirectly.

We appreciate that these requirements are particular to the existing U.S. regulatory scheme and could be difficult to implement in the U.K. framework. We believe, however, that the concepts listed above could be applied in some form and would effectively mitigate many concerns associated with "abusive" short selling. Our letter to the SEC includes further description of Reg SHO and new Rule 204T, and we respectfully commend it to the FSA.[30]

We recommend that regulators, including the FSA, conduct fact-finding investigations to determine the level of "naked" short selling that has occurred and provide the results to investors and market participants. Any additional prohibitions on "naked" short selling would likely have limited benefits to capital markets, if any, and could significantly reduce market efficiency, and should be not be adopted by the FSA.

## III. SHORT POSITION REPORTING

### Public Disclosure of Short Position Information

The FSA should require reporting of short positions only to the FSA, and keep any reported information confidential. As described in our January Letter, public disclosure of short position information may increase market volatility, mislead investors, and harm the proprietary trading strategies of money managers and their investors. We encourage the FSA to disclose whether it has identified any abusive short selling practices that public disclosure is designed to address.

We believe public disclosure disadvantages those companies whose stock is shorted and the investors who are long in that stock. As described below, an investor may short a stock for risk management purposes, but the investing public would mistakenly interpret disclosure of that information as a negative view on a company's prospects. Shorting of certain stocks may actually increase as other market participants follow firms' publicized short positions.

A number of pension, endowment and foundation investors in the U.S. have indicated to our members that because of headline risk, they would likely withdraw their investments from investment vehicles engaged in short selling if they were required to publicly disclose short sales or short positions. In the long-term, pension, endowment and foundation investors would forego diversification and risk management benefits provided by alternative investment vehicles. In addition, some issuers have stated that if they determine which firms have been shorting their securities, they will cease communications with analysts of those firms and exclude them from information sessions. Such a result would throw sand in the gears of capital markets by limiting the free flow of information essential for informed investments and vibrant markets.[31] We are concerned that the public disclosure of detailed short positions would have long lasting negative effects on U.K. markets by having a chilling effect on the information and transparency provided by issuers, as well as subjecting investors to possible retaliation by issuers.

Public disclosure of short position information could have unintended consequences to hedging strategies of investors. Hedging strategies are a critical risk management tool of investors and enable

[30] Letter from Stuart J. Kaswell, Executive Vice President and General Counsel, Managed Funds Association, to Florence E. Harmon, Acting Secretary, Securities and Exchange Commission, dated Dec. 15, 2008, available at: http://www.managedfunds.org/downloads/MFA%20Rule%20204T%20Comments.12.15.08.final.pdf

[31] Such threats also raise questions under U.S. Regulation FD, 17 CFR §243.100 *et seq*. *Cf.* FSA Handbook, Market Abuse, §1.5 *et seq*.

investors to make investments on the long side of the market. Short selling is an essential component of a wide range of *bona fide* hedging strategies by which investors provide liquidity to the financial markets. Public disclosure of short positions might discourage investors from engaging in short sale transactions for hedging purposes, reducing investors' ability to manage risk, and decreasing market liquidity and capital formation. While these concerns would be reduced if an investor's net short position for a particular security remains below the disclosable amount, investors frequently hedge risk through short sales of different issuers with highly correlated share prices (*e.g.*, companies in the same industry sector). Investors engaging in these hedging strategies are not able to net their short sales under the disclosure requirements.

Public disclosure of information could permit other market participants to unfairly reverse engineer the proprietary trading strategies of an investor. Even if only temporary, public disclosure would likely cause harm to the proprietary trading strategies of money managers, and by direct implication the billions of dollars invested in those strategies by investors such as pensions, endowments and foundations, as competitors will be able to use the publicly disclosed information not only to profit in the short term from the known positions, but also to reverse engineer the trading strategies themselves.

As compared to these costs to the market from public disclosure of short position information, we believe that the FSA has not clearly demonstrated that public disclosure would provide any benefits to capital markets. The FSA asserts that benefits of public disclosure would include: (i) enhanced pricing efficiency, (ii) increased detection of abusive short selling, (iii) additional notice to the FSA as to when investors may be overreacting to price changes, and (iv) a deterrent effect on market participants seeking to establish large short positions.[32] We recommend that the FSA conduct further investigation as to whether public disclosure of individual short positions would in fact accomplish these objectives, and in particular analyze whether its current public disclosure requirement has done so.

In Annex 1 of the Paper, the FSA explains that it did not find any "literature specifically assessing the effects of requirements to disclose individual short positions" on pricing efficiency. Instead, the FSA looked to individual disclosures of trades by corporate insiders and Major Shareholder Notifications, concluding that "disclosing individual long positions may provide valuable information to the market." Disclosure of long positions by corporate insiders, however, is of limited use in evaluating the effect of short position disclosures by individual investors, and as the Paper correctly indicates, the "results cannot be directly read across to mandatory individual disclosure of short positions." In fact, the academic literature cited in Annex 1 strongly supports the view that short selling contributes to pricing efficiency.[33] If a public disclosure requirement causes investors to artificially reduce their level of short selling to remain below the disclosure threshold, as anticipated by the FSA, the disclosure requirement would lead to diminished pricing efficiency in U.K. markets.

MFA strongly support efforts to prevent, detect and punish manipulative conduct. As noted above, during its consideration of short selling, the FSA should disclose whether it has identified any potential manipulation of securities prices through spreading of false information, instances of

[32] Pages 24-25.

[33] *See e.g.*, Boehmer, E., Jones, C. M., Zhang, X., *Shackling Short Sellers: The 2008 Shorting Ban*, 2008a, preliminary draft, www2.gsb.columbia.edu/faculty/cjones/ShortingBan.pdf; Bris, A., Goetzmann, W. N., Zhu, N., *Efficiency and the Bear: Short Sales and Markets Around the World*, 2007, Journal of Finance, Vol. 59, No. 4.

manipulative "naked" short selling or other related market abuses as described in the Paper.[34] If such abusive conduct is identified, the FSA should consider taking actions more directly applicable to the specific type of manipulation.[35] A public disclosure obligation applicable to all U.K companies and investors is an overly broad response to potential manipulative conduct that has not been sufficiently identified.

The FSA explains in the Paper that public disclosure of short position information would provide it with more advance warning of conditions in which it may need to consider regulatory intervention. It does not, however, cite to evidence of a relationship between short positions and extreme market conditions. The literature reviewed by the FSA, in fact, concludes that short sales "do not affect the frequency of extreme negative returns."[36] The FSA similarly found no correlation between negative stock returns and increased levels of stock lending in its analysis of the effects of the Ban.[37] Moreover, setting aside the connection between short positions and market instability, the FSA could receive equivalent information from investors through private reporting.

Finally, the FSA suggests that public disclosure would discourage an individual investor from additional short selling as its position approaches the disclosure threshold, reducing the risk of disorderly markets. As noted above, we remain deeply concerned about the ongoing crisis within global financial markets. A public disclosure requirement, however, would be overly broad and discourage investors from taking short positions exceeding the disclosure threshold during times of market stability. If the disclosure requirement effectively acted as a restraint on short selling, as proposed in the Paper, it would impose the same pernicious effects on market efficiency, liquidity and price discovery as a short selling prohibition, and would discourage investors from fully implementing risk management strategies or taking directional short positions based on proprietary research. For these reasons, we believe a public disclosure requirement would provide only limited benefits, if any, and would not enhance market confidence or lead to greater market stability.

**Private Reporting of Short Position Information to the FSA**

The significant costs to the market resulting from public disclosure described above could be substantially mitigated through private reporting of short position information by brokers or exchanges to the FSA. Initially, brokers or exchanges could provide short position information to the FSA confidentially on an aggregate basis. The FSA could then request at any time specific information for individual investors if it suspected or became concerned about manipulation of a particular security. Confidential reporting by brokers or exchanges would provide the FSA with the significant benefits of more comprehensive short selling information and enhanced tools to identify manipulative activity on a security-by-security basis, and also reduce the costs associated with public disclosure.

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[34] MFA recently submitted a comment letter to a rule proposal by FINRA relating to the spreading of rumors. See letter from Stuart J. Kaswell, Executive Vice President, Managed Funds Association, to Marcia E. Asquith, FINRA, dated Dec. 18, 2008, available at: http://www.managedfunds.org/downloads/MFA%20Comments%20FINRA%20R.2030.12.18.08.pdf.

[35] For example, as further described below, Rule 105 of U.S. Regulation M is designed to address specifically the concerns of potential manipulation in connection with short sales of a security that is the subject of a public offering.

[36] *See* Bris, A., Goetzmann, W. N., Zhu, N., *Efficiency and the Bear: Short Sales and Markets Around the World*, 2007, Journal of Finance, Vol. 59, No. 4.

[37] Annex 2, page 4.

As noted in the Discussion Paper, the U.K. regulatory framework currently does not require that market participants mark orders long or short.[38] If the FSA were to adopt an order marking requirement, brokers could gather and retain current, aggregate short sale information, including data on any fails to deliver or "naked" short sales.[39] The additional information would provide regulators with a broader perspective of shorting activity for a particular security than could be compiled solely from reporting of short positions by individual investors, and would be more useful in distinguishing manipulative "naked" short selling from unintentional failures to deliver. Brokers or exchanges could report all short positions, including those below any *de minimis* thresholds. Because brokers generally have more sophisticated trading and data processing systems than investors, the burden imposed on brokers would be substantially less than that imposed on individual investors. In addition, these automated systems could allow more frequent reporting, if required, and provide data in a more efficient and user-friendly format than reporting by individual investors. Reporting by individual investors for all U.K stocks would result in the FSA receiving large volumes of short position information from individual investors that it then must extensively analyze.

Under this reporting regime, the FSA would receive information from fewer reporting entities and use fewer resources to more efficiently identify and investigate manipulative conduct. Risks to market stability as a result of manipulative conduct can better be addressed through reporting on a security-by-security basis. Such a reporting regime, for example, could have provided regulators with more current, usable information than reporting by investors during the past year as the prices of stocks of certain financial institutions experienced significant daily fluctuations. Once the FSA identified a particular security or industry as being a potential concern regarding fraudulent activity, it would have precise data available to investigate, or it could request from brokers additional short sale information for the security or industry.

After receiving short information from brokers or exchanges on a security-by-security basis, the FSA could publicly disclose aggregate short positions. As noted in the Discussion Paper, aggregate disclosure of short positions would let market participants evaluate the effect of short selling on the price of a security based on the aggregate number of shares that have been sold short.[40] Such aggregate information would likely be more beneficial to market participants than public disclosure of positions by individual investors, and would avoid the costs of revealing investors' positions.

For example, in the U.S., under FINRA Rule 4560, member firms must report total short positions in all customer and proprietary firm accounts in securities listed on a national securities exchange and over-the-counter equity securities to FINRA on a semi-monthly basis.[41] Member firms report short interest positions through FINRA's Regulation Filing Applications.[42] FINRA then provides

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[38] Discussion Paper, page 27. Investors in the U.S. regularly report order marking information to brokers under Rule 200(g) of Reg SHO.

[39] In addition, brokers could also gather information on the availability of a stock to borrow pursuant to a "locate" requirement.

[40] Discussion Paper, page 27.

[41] See SR-FINRA-2008-033, effective Dec. 15, 2008 and Order Approving Proposed Rule Change and Amendment No. 1 Thereto To Adopt FINRA Rule 4560 (Short-Interest Reporting) in the Consolidated FINRA Rulebook, SEC Release No. 34-58461 (Sept. 4, 2008), 73 FR 52710 (Sept. 10, 2008). Over-the-counter equity securities include any equity security that is not listed on a national securities exchange.

[42] Available at https://regfiling.finra.org.

aggregate short interest data on a security-by-security basis to the respective exchanges on one uniform date at the end of each short interest reporting cycle for dissemination purposes. Under a system of reporting by brokers or exchanges, the FSA could adopt similar short interest reporting procedures or disclose other aggregated statistics it determines would be beneficial to market participants.

In the Discussion Paper, the FSA estimates that the costs of implementing a marking and aggregation regime to brokers, trading platforms and the FSA would be prohibitively expensive and higher than those involved in disclosure of significant individual short positions. While we recognize the potential initial costs of order marking and aggregation, we believe that the long-term benefits of such a system would outweigh the short-term implementation costs for U.K. firms. In some cases, firms that operate in U.S. and other markets are already subject to order marking requirements and would have lower implementation costs.[43] More generally, private reporting to the FSA and aggregate public disclosure of short position information would provide market participants with increased transparency while avoiding potential harm to investors' trading strategies. It would also avoid a chilling effect on the benefits short selling provides to U.K. markets, including enhancing liquidity, increasing market efficiency, and facilitating price formation.

In the U.S., institutional investors privately report short position information to the SEC on a weekly basis pursuant to Rule 10a-3T, and such information is kept confidential. We believe this private reporting structure has provided the SEC with important short selling data while avoiding harmful effects to the markets associated with public disclosure. In order to assure that such information remains non-public, we have recommended that the SEC assert appropriate exemptions from the U.S. Freedom of Information Act to any claim for information filed under the statute. If the FSA were to adopt a private reporting requirement, we recommend that it also exempt such information from any laws that could require public disclosure of government materials upon request or otherwise. If short position information were subject to the U.K. Freedom of Information Act, it could create a substantial risk of public disclosure. The FSA should consider any implications of the statute that could limit the efficacy of private reporting, and assert any applicable exemptions for short position information that is reported on a confidential basis.

The Paper also requests comment on whether market makers should continue to be exempt from disclosure obligations when they are acting in the capacity of a market maker. We believe that market makers generally could be subject to a requirement to privately disclose short position information to the FSA, however, as described below, any requirement should include a sufficiently high reporting threshold to mitigate the burden on market participants.

**Short Position Reporting Threshold**

The FSA proposes to expand the existing disclosure obligations to require individual investors to report net short positions for all U.K. stocks, and increase the reporting threshold from 0.25% to 0.50% of the issued share capital of a company. As noted in our January Letter, we recommend that the *de minimis* reporting threshold of a net short position which represents an economic interest of the issued capital of certain financial companies be 2.0% or higher, and that the disclosure obligations not be extended beyond financial stocks.

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[43] A number of jurisdictions, including Australia, Canada, Hong Kong, and Japan, currently require order marking for short sales. *See* Appendix IV of the IOSCO Technical Committee's Consultation Report, Regulation of Short Selling (March 2009).

An extension of the disclosure requirement would exacerbate the negative consequences to market efficiency and compliance burdens to investors described above, and we strongly request that the FSA not broaden the disclosure of short positions beyond stocks of financial companies. As noted above, public disclosure may discourage an individual investor from additional short selling as its position approaches the disclosure threshold, and as a result, a 0.50% disclosure threshold applicable to all companies could significantly reduce the liquidity of U.K. stocks.

The disclosure requirements, along with the Ban, were initially adopted in response to price declines of shares of financial companies, and we believe an extension to other companies would be unwarranted. As noted above, studies have confirmed that the price declines of restricted stocks were a result of long sales, rather than short sales. We encourage the FSA to determine whether in fact market abuse in connection with short selling contributed to market volatility during this period, and whether the Ban and disclosure requirements reduced any such abuse. The FSA should review the efficacy of the disclosure requirement before it considers extending it to shares of companies where few, if any, concerns of market abuse have been raised.

We believe a reporting threshold of 0.50% of the issued capital of a company does not strike an appropriate balance between providing information to regulators that is both comprehensive and relevant. Short sales and short positions less than 2.0% of an issuer's securities issued and outstanding are unlikely to be meaningful in identifying fraudulent short sale activity. Particularly for large issuers, short sales and short positions below 2.0% are not significant to the market, and should be considered *de minimis*. Moreover, limiting disclosure to more significant positions permits a regulator to more accurately assess risks rather than being inundated with data.

**Frequency of Reporting**

Currently, investors must disclose net short positions of at least 0.25% of the issued share capital of a company on a daily basis, unless there is no change in the size of the short position. We recommend that any reporting of short sale information be quarterly. More frequent filings, such as on a daily or weekly basis, are burdensome for individual investors, especially smaller investors with less sophisticated information technology systems. For a firm to establish its net economic exposure in a company's issued share capital, as required, it must perform complex calculations across all derivative positions in the company on a delta adjusted basis. These calculations can be extremely challenging for firms, and in some instances may pose burdens that cannot be met with existing personnel and resources. Any extension of reporting obligations beyond stocks of financial companies would compound the complexity of determining a firm's net economic exposure, and would significantly increase the burden to comply with the disclosure obligation.

Investors already are subject to a substantial number of reporting requirements for long positions throughout many European jurisdictions. Additional daily short selling reporting requirements in the U.K. would add to the already significant cumulative compliance costs faced by investors that participate in the global capital markets.

**Reporting Requirement for Rights Issues**

In June 2008, prior to its adoption of disclosure requirements for short positions in U.K. financial companies, the FSA issued rules requiring investors to disclose a net short position of 0.25% or above in companies undertaking rights issues. In the Discussion Paper, the FSA proposes to retain this requirement in addition to reporting requirements for companies not undertaking rights issues. We believe that any reporting requirements for short positions in companies undertaking rights issues should be consistent

with other short position reporting requirements. Accordingly, we recommend that brokers or exchanges provide this information privately to the FSA when an investor's short position exceeds 2.0% of a company's issued share capital. As noted above, public disclosure of short positions, including companies undertaking rights issues, may increase market volatility, potentially mislead investors, and harm the proprietary trading strategies of money managers and their investors.

If the FSA were to continue to require a separate disclosure regime for short positions of companies undertaking rights issues, we recommend the FSA implement certain changes to the disclosure requirements. First, any disclosure requirement for a rights issue should include only short positions entered into after the date of the announcement of the rights issue and short positions entered into during a relevant time period (*e.g.*, five days) prior to the date of announcement.[44] Under the current requirement, an investor that establishes a net short position well in advance of a rights issue would trigger the disclosure obligation. The entering into of a short position significantly prior to the announcement of a rights issue does not present the potential for market abuse, and should not trigger a disclosure obligation.

Second, the disclosure requirement should not apply to all companies listed in the U.K., and instead should be limited to short positions of the shares of companies where the U.K. is the primary listing location. Under the current requirement, for example, a French company whose primary listing location is Euronext Paris may also have shares listed in the U.K. as a secondary listing location. If the company undertook a rights issue, only U.K. investors subject to the FSA's requirements would be required to disclose a net short position of at least 0.25% of the issued shares. This requirement could be inconsistent with existing rules in the jurisdiction where the company's primary regulator is located, and cause investors located in different countries to be subject to unequal requirements. The FSA should modify its rule to exclude the disclosure of short positions held in a company with a majority of shares listed in a foreign jurisdiction.[45]

**Credit Default Swaps**

The Paper requests comment on whether the FSA should adopt rules with respect to credit default swaps and short selling. Over the past several months, policy makers and market participants in Europe and the U.S. have engaged in extensive discussions and preparations designed to restructure the regulatory framework governing the credit default swaps market. Under current proposals, the credit default swaps market will differ substantially from its current form, including increased regulatory oversight and the clearing of credit default swaps through one or more central counterparties. We recommend that the FSA postpone consideration of credit default swaps until these changes are implemented, and thereafter analyze whether market abuse is occurring in connection with short selling.

## IV. OTHER CONSTRAINTS ON SHORT SELLING

[44] *See e.g.*, Rule 105 of U.S. Regulation M, which prohibits market participants from engaging in short sales of a security that is the subject of a public offering and purchasing the security from an underwriter or broker or dealer participating in the offering if such short sale was effected during the period that is the shorter of the period: (i) beginning five business days before the pricing of the offered securities and ending with such pricing; or (ii) beginning with the initial filing of such registration statement or notification and ending with the pricing.

[45] In order to further address its concerns, the FSA could require that any excluded company be subject to a sufficient level of regulatory oversight in its jurisdiction.

Along with policy makers, MFA and its members remain deeply concerned about the ongoing crisis within global financial markets and support timely and targeted initiatives aimed at preventing the crisis from worsening. The root cause of this crisis has been the inadequate risk management practices of prime brokers, banks and other financial institutions. Investors, including hedge funds, should not be blamed for accurately predicting that the share prices of poorly managed firms were likely to decline. As noted, we believe short selling plays an integral role in the proper functioning of markets, as it contributes to efficient price discovery, increases market liquidity, and promotes capital formation, among other benefits.

In June 2007, the SEC rescinded its "uptick rule,"[46] which was originally adopted in 1938 to restrict short selling in a declining market. The uptick rule provided that, subject to certain exceptions, a listed security may be sold short: (i) at a price above the price at which the immediately preceding sale was effected (plus tick), or (ii) at the last sale price if it is higher than the last different price (zero-plus tick). Short sales were not permitted on minus ticks or zero-minus ticks, subject to narrow exceptions. Prior to its decision to rescind the rule in 2007, the SEC engaged in comprehensive studies, investigations and a pilot program to evaluate the rule. Based on its analysis, the SEC concluded that the continued sophistication of trading activities, for example through decimal pricing, high-volume trading and sub-penny quotes, significantly reduced the uptick rule's efficiency in modern markets.

The SEC is currently seeking public comment on whether it should impose short sale price restrictions or circuit breaker restrictions, and whether such measures would help promote market stability and restore investor confidence.[47] Options under consideration by the SEC include: a short sale price test based on the national best bid (modified uptick rule), a short sale price test based on the last sale price or tick (uptick rule), a circuit breaker that would ban short selling in a particular security for the remainder of the day if there is a severe decline in price in that security, and a circuit breaker that would impose one of the two price tests in a particular security for the remainder of the day if there is a severe decline in the price of the security. We are in the process of responding to these proposals, and encourage the FSA to review our comments when they become available.

(Continued on next page)

[46] Former Rule 10a-1.

[47] Amendments to Regulation SHO, SEC Release No. 34-59748 (Apr. 10, 2009), 74 FR 18042 (Apr. 20, 2009).

## V. CONCLUSION

MFA welcomes the opportunity to further discuss any of the recommendations made above, and we would also be pleased to respond to any additional inquiries as the FSA considers the appropriate short selling regime. We would like the opportunity to meet with you and discuss any further questions or comments prior to the finalization of any proposals. If you have any questions or comments, please contact Matthew Newell or the undersigned at (202) 367-1140.

Respectfully submitted,

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