



January 9, 2009

**Via Electronic Mail:** [cp09\\_01@fsa.gov.uk](mailto:cp09_01@fsa.gov.uk)

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

**Re: Consultation Paper 09/1, Temporary Short Selling Measures**

Dear Mr. Sie:

Managed Funds Association (“MFA”)<sup>1</sup> welcomes the opportunity to provide comments to the Financial Services Authority (“FSA”) in response to Consultation Paper 09/1, Temporary Short Selling Measures (the “Consultation 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.

Set out below are responses to the temporary short selling measures proposed in the Consultation Paper (the “Measures”). Because the FSA intends to publish a separate consultation paper describing long-term options for the short selling regime within one month, our comments are limited to the proposed short selling measures in the Consultation Paper. MFA has recently submitted general letters to the U.S. Securities and Exchange Commission (“SEC”)<sup>2</sup> in response to its adoption of two interim temporary final rules relating to short selling,<sup>3</sup> and the International

<sup>1</sup> 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.

<sup>2</sup> 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>.

<sup>3</sup> 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).

Organization of Securities Commissions Technical Committee Task Force on short selling.<sup>4</sup> We would be pleased to provide any additional information the FSA might find useful during its review, and intend to submit a response to any additional consultation papers on short selling.

## **I. SHORT SELLING BAN**

In response to extreme market volatility, in September 2008 the FSA took emergency measures by prohibiting the active creation or increase of net short positions in U.K. financial sector companies (the “Ban”). The FSA intended the Ban to prevent market abuse, protect the fundamental integrity and quality of markets and to guard against further instability in the financial sector.<sup>5</sup> The Measures would allow the Ban to expire on January 16, 2009. The FSA, however, would keep the position under review and stand ready to reintroduce the Ban if it deems it necessary without consulting industry participants.

We support the expiration of the Ban on January 16 and recommend that the FSA not reintroduce it or any further prohibitions on short selling. As managers of alternative investment vehicles, our members share the FSA’s concerns with respect to investor protection and the orderly functioning of markets. We believe the Ban is contrary to maintaining open, fully functioning 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. Should the FSA determine to reintroduce the Ban, 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.

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 by allowing investors with negative information, who do not hold stock, to trade on their information.” In addition, short selling can “enhance liquidity by increasing the number of potential sellers,” and increase market efficiency.<sup>6</sup> Similarly, the SEC recently affirmed that “short selling plays an important role in the market for a variety of reasons, including contributing to efficient price discovery, mitigating market bubbles, increasing market liquidity, promoting capital formation, facilitating hedging and other risk management activities, and importantly, limiting upward market manipulations.”<sup>7</sup> We strongly agree that short selling provides capital markets with necessary liquidity and plays an important role in the price discovery process. Markets are more efficient, and securities’ prices are more accurate, because investors with capital at risk engage in short selling.

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<sup>4</sup> 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>.

<sup>5</sup> Consultation Paper at page 5.

<sup>6</sup> Consultation Paper at page 4.

<sup>7</sup> Statement of Securities and Exchange Commission Concerning Short Selling and Issuer Stock Repurchases, SEC Release 2008-235 (Oct. 1, 2008).

We believe the Ban had the adverse effects of further reducing liquidity and increasing volatility in the capital markets. In this vein, SEC Chairman Cox recently explained that the biggest mistake of his tenure was the SEC's prohibition on short sales of the shares of 799 financial companies issued in September 2008 ("Prohibition Order").<sup>8</sup>

In addition, 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.

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.<sup>9</sup> We also encourage the FSA to investigate whether the Ban has been effective in preventing any market manipulation. In addition, we urge the FSA to examine and disclose its findings as to any adverse consequences to the capital markets, including effects as to market efficiency, liquidity and price discovery, and base any further actions on the results of this review and other relevant facts. Academics studying the effects of the Prohibition Order<sup>10</sup> have indicated that the Order had negative effects on capital markets.<sup>11</sup> For these reasons, we believe that the Ban should expire on January 16 and should not be reintroduced.

## II. REPORTING OF SHORT SALE INFORMATION

We request that the FSA require investors to report only short positions to the FSA, and that the FSA keep any reported information confidential. We strongly believe that public disclosure of short sale information has the perverse effects of increasing market volatility, being potentially misleading to the public, and causing harm to the proprietary trading strategies of money managers and harming fund investors, such as pension plans, endowments and foundations.

We encourage the FSA to investigate and communicate to investors whether disclosure of short positions has reduced the potential for the misleading effects of short selling described in Chapter 2 of the Consultation Paper. In particular, the FSA should examine whether any willful misconduct, "scaremongering" or other market abuses occurred prior to the adoption of the disclosure rules.<sup>12</sup> The FSA should also examine and disclose its findings as to any adverse consequences to the capital markets, including effects as to market efficiency, liquidity and price discovery, and base any further actions on the results of this review and other relevant facts.

<sup>8</sup> SEC Chief Defends his Restraint, Amit R. Paley and David S. Hilzenrath, Page A01, Washington Post, December 24, 2008.

<sup>9</sup> 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>.

<sup>10</sup> SEC Order Halting Short Selling in Financial Stocks, SEC Release No. 34-58592 (Sept. 18, 2008), 73 FR 55169 (Sept. 24, 2008).

<sup>11</sup> See e.g., Shorting Financial Stocks Should Resume, Arturo Bris, Wall Street Journal, September 29, 2008.

<sup>12</sup> Consultation Paper at page 4.

If the FSA determines that short position disclosure to regulators is necessary, we believe that prime brokers and clearing brokers could more efficiently report short sale information, rather than individual investors. Reporting by prime brokers and clearing brokers would provide regulators with more comprehensive market information with respect to short selling and better enable them to respond to any potential manipulation in the securities markets caused by short selling. Regulators could review consolidated information on a security-by-security basis from prime brokers and clearing brokers more easily than the current filings on an investor-by-investor basis. 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 could request additional short sale information from brokers for the security or industry. Such a reporting regime could have provided regulators with more current, usable information than reporting by investors, for example, over the past several months as the prices of stocks of certain financial institutions experienced significant daily fluctuations.

If the FSA requires reporting of short sale information by individual investors, we suggest the following principles that are designed to provide regulators with more useful short sale information while mitigating undue burdens to individual investors. The disclosure requirements have imposed significant technological and operational burdens on investors, and compelled firms to allocate considerable resources to disclose short positions. Specifically, we recommend that reporting rules, among other things:

- Mandate that any reporting be only to the FSA and be treated as confidential.
- Require reporting a net short position which represents an economic interest of 2.0% or more of the issued capital of a company. Short positions below 2.0% are not significant and individual investors should not have to report that information.
- Require additional reporting only if the short position changes by 2.0% above the threshold.
- Require reporting on a quarterly basis.
- Require reporting only of net short positions in financial companies.

We elaborate on each of these points below.

#### *1. Public Disclosure*

The FSA only should require investors to report short positions to the FSA, and keep any reported information confidential. Public disclosure of short sale information may increase market volatility, potentially mislead investors, and harm the proprietary trading strategies of money managers and their investors.

We believe public disclosure probably disadvantages those companies whose stock is shorted and the investors who are long in that stock. An investor may short a stock for risk management purposes, but the investing public might misinterpret 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 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 limit the free flow of information essential for informed investments and vibrant capital markets.<sup>13</sup> We are concerned that the public disclosure of detailed short positions would have long lasting negative effects on our 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 sale and short position information could have unintended consequences to hedging strategies of investors. Hedging strategies are a critical risk management tool of investors and enable 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. We acknowledge that these concerns would be reduced in the case of hedging strategies where the net short position of an investor does not reach the disclosable amount.

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.

The concerns noted above could be substantially mitigated through reporting of short sale information by prime brokers and clearing brokers. Initially, brokers could provide short sales and short position information to the FSA confidentially on an aggregate basis. The FSA could request specific information as to short sales and short positions of individual investors if it suspected or became concerned about manipulation of a particular security. As described above, confidential reporting by prime brokers and clearing brokers would provide the FSA with enhanced tools to identify manipulative activity on a security-by-security basis. The FSA would also have the ability at any time to request the short sale and short position information of any individual investor for any security. Such a reporting system would reduce the problems associated with public disclosure while providing regulators with more comprehensive short selling information.

## 2. *De Minimis Threshold*

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. The current reporting threshold of 0.25% 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

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<sup>13</sup> 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.*

for large issuers, short sales and short positions below 2.0% are not significant to the market, and should be considered *de minimis*.

3. *Incremental Reporting*

We support the proposal in the Measures that investors would report only those short position changes that are significant. We believe that short position changes of 0.1% are not meaningful for the FSA's purposes of identifying market abuse, and propose that short position changes be reported at 2.0% from the threshold. Reporting of short position changes at this level would provide more useful information to the FSA and reduce the significant burden imposed on investors to report at changes of 0.1%.

4. *Frequency of Reporting*

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. Quarterly reporting would alleviate reporting burdens and provide regulators with comprehensive short sale information.

5. *Scope of Disclosure*

Recent press reports have indicated that the FSA is considering the costs and benefits to an extension of the disclosure requirement to stocks of firms other than financial companies. We believe such an extension would be unwarranted, and request that the FSA describe any basis upon which it would take such action. 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.

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**III. 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 discuss any further questions or comments prior to the FSA's upcoming proposals on long-term options for short selling, and would be delighted to meet with the FSA. If you have any questions or comments, please contact Matthew Newell or the undersigned at (202) 367-1140.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Stuart J. Kaswell". The signature is fluid and cursive, with a large, sweeping initial "S".

Stuart J. Kaswell  
Executive Vice President and General Counsel

cc: Sally Dewar – Managing Director, Financial Services Authority