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

May 4, 2009

Via Electronic Mail: ShortSellingReport@iosco.org

Mr. Greg Tanzer
Secretary General
IOSCO
C / Oquendo 12
28006 Madrid
Spain

Re: International Organization of Securities Commissions Technical Committee, Public Comment on Regulation of Short Selling

Dear Mr. Tanzer:

Managed Funds Association ("MFA")[1] welcomes the opportunity to provide comments to the International Organization of Securities Commissions Technical Committee's ("Technical Committee") Consultation Report, Regulation of Short Selling ("Consultation Report") as it develops principles to establish a common international approach and guidance for the regulation of short selling. MFA and its members appreciate and support the efforts of the Technical Committee's Task Force on Short Selling to develop coordinated regulatory solutions and to eliminate gaps in various regulatory approaches to short selling. We are pleased that the Technical Committee is providing leadership in addressing issues associated with short selling from a global perspective. 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.

The discussion below follows our letter submitted to the Technical Committee in response to its request for comments on short selling in December 2008.[2] In our December Letter, we described certain characteristics of the U.S. regulatory short selling regime that we believe have been effective in

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[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] *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 ("December Letter").

preventing potential disruption while protecting the important role short selling plays in the market by providing price discovery, increasing market efficiency and liquidity, reducing market bubbles, and permitting hedging and risk management activities. We also recommended certain changes to recently adopted short selling reporting regimes across different jurisdictions that would provide regulators with more timely, useful information while mitigating any burden to individual investors.

We are pleased that the four principles recommended by the Technical Committee in the Consultation Report are consistent both with the existing U.S. regulatory scheme for short selling and proposed improvements to the scheme described in our December Letter. The discussion below includes comments previously submitted to the Technical Committee in the December Letter, as well as recommendations provided in response to recent short selling proposals by the U.S. Securities and Exchange Commission ("SEC")[3] and the U.K. Financial Services Authority ("FSA").[4] These letters include additional responses to specific proposed rules, and we respectfully commend them to the Technical Committee.

I. Market Benefits of Short Selling and Derivatives Trading

Short selling, as recognized by the SEC, "plays an important role in the market for a variety of reasons, including providing more efficient price discovery, mitigating market bubbles, increasing market liquidity, facilitating hedging and other risk management activities and, importantly, limiting upward market manipulations."[5] We strongly agree that short selling, along with derivatives trading, provide capital markets with necessary liquidity and play 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.[6]

Short selling and other techniques, including listed and over-the-counter derivatives trading, are also critical risk management tools for 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.

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[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.

[4] Letters 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,and dated May 8, 2009, available at: http://www.managedfunds.org/comment-letters.asp.

[5] Statement of Securities and Exchange Commission Concerning Short Selling and Issuer Stock Repurchases, SEC Release 2008-235 (Oct. 1, 2008). Likewise, the FSA recognizes that short selling 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. *See* Consultation Paper 09/1, Temporary Short Selling Measures.

[6] *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.

Take, for example, the decision to buy a convertible bond, which is an important manner by which companies, including distressed companies, seek to raise capital. Most investors in convertible bonds seek to hedge their market risk by shorting stock to maintain a sufficient "delta" hedge. Under such a strategy, when the price of the underlying security goes up, owners of convertible bonds sell short to hedge their exposure, and when the price of the underlying security goes down, they buy shares of the security to cover short positions and limit volatility to the down side. Similarly, the same dynamic occurs with respect to volatility strategies and option volatility positions, where participants attempt to cover short positions when prices fall and sell short when prices rise. Limiting an investor's ability to manage the risk of their long investments through short positions, similarly limits investors' ability to invest on the long side of the market and provide public companies with necessary funding and market liquidity.

Short sale regulation that is overly restrictive impairs market liquidity and capital-raising among issuers by making it harder for investors to borrow securities and invest on the long side. Generally, a fund's risk management system and/or trading strategy will not allow the fund to increase its long positions if it is not adequately hedged.

For example, the short selling prohibitions on financial stocks adopted by the FSA and the SEC in September 2008, had the adverse effects of reducing liquidity and increasing volatility in the capital markets. In this 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.[7] Academic studies of the effects of the prohibitions conclude that the affected stocks exhibited both reduced market quality[8] and liquidity[9] 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.[10] For example, the FSA noted that in the sixty days following the introduction of its short selling 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%.[11]

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. A recent report issued by the Hong Kong Securities and Futures Commission supports this approach and affirms that short selling improves market efficiency, increases liquidity, and helps price discovery.[12]

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

[8] 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.

[9] 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.

[10] Consultation Paper 09/1, Annex 2, page 2.

[11] Annex 2, pages 6 and 7.

[12] 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.

II. APPROPRIATE SHORT SELLING CONTROLS

Under the Technical Committee's first principle, "short selling should be subject to appropriate controls to reduce or minimise the potential risks that could affect the orderly and efficient functioning and stability of financial markets," and regulation should at a minimum, impose "a strict settlement (such as compulsory buy-in) of failed trades." In addition to settlement requirements, the Report suggests that short selling controls may include pre-borrowing or "locate" requirements, price restriction rules or "flagging" of short sales.

We support this key principle and believe that the U.S. Regulation SHO ("Reg SHO") short selling framework, which incorporates these controls, has been highly effective in substantially reducing fails to deliver without disruption to the market.[13] Reg SHO also has created operational efficiencies that contributed to tighter bid-ask spreads and more liquid markets. We urge that any future regulation of short selling continue to limit disruption to the market and not interfere with timely and best execution of trades, and offer below a discussion of Reg SHO as a case study and model for international regulatory standards.

As a first step 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. In its request for comments related to short selling, the 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.

The FSA has described 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."[14] The SEC has described "naked" short selling as occurring when "a seller does not borrow or arrange to borrow securities in time to make 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 described 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."[15] 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.[16]

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

[14] Discussion Paper 09/1, Short Selling ("FSA Discussion Paper").

[15] Amendments to Regulation SHO, SEC Release No. 34-58773 (Oct. 14, 2008), 73 FR 61706 (Oct. 17, 2008) ("Regulation SHO Release"). *See also* "Naked" Short Selling Anti-Fraud Rule, SEC Release No. 34-58774 (Oct. 14, 2008), 73 FR 61666 (Oct. 17, 2008).

[16] *See id.* at 61715.

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),[17] as it may lead the investor to fail to deliver the stock on its settlement date. Naked short selling can be disruptive to the normal clearing and settlement process and result in delivery and settlement delays, as well as result in systematic disturbances. However, MFA believes it is important that any efforts to address "naked" short selling not restrict legitimate short selling.

MFA members have strong incentives to prevent failures to deliver from occurring. Fails 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 being closed-out. 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 per minute with a broker-dealer.[18] 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 closes out a large number of the trades placed with it.

A. Regulation SHO

We believe appropriate regulatory controls for short selling include:[19]

- 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.

In the United States, Reg SHO has benefited investors by providing a regulatory framework that creates greater market stability, market liquidity and investor confidence. In developing Reg SHO, the SEC focused on modernizing short sale regulation, in a way that maintains the benefits of short selling

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[17] 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 regulators in other jurisdictions may use different terminology to describe similar market participants and concepts. However, MFA believes that members of the Technical Committee are familiar with the SEC's terminology.

[18] The advent of algorithmic trading has enriched our financial markets by adding even more depth and liquidity to our markets. As previously explained, algorithmic traders may buy and sell thousands of securities a minute, injecting the market with liquidity as they trade. A consequence of the SEC's July 15th emergency order imposing a pre-borrow requirement on investors was that algorithmic traders had to switch from automated trading to manual trading, a more time-consuming and inefficient way of trading. This limited the amount of liquidity such traders were able to provide to the market.

[19] 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.

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.

1. Price Test

In June 2007, the SEC rescinded its "uptick rule,"[20] 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.[21] 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 reviewing the merits of each of the proposed measures, and encourage members of the Technical Committee to review our comments when they become available.

2. Requirement to Locate Securities

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 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 made significant investments in technology to build their operating systems. 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.[22] For an easy-to-borrow security, many buy-side firms employ an automated trading system that

[20] Former Rule 10a-1.

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

[22] Many buy-side firms have made considerable investments in their systems to automate the locate process. By automating the locate process, firms are effectively able to contact various lenders to confirm the availability of securities to settle trades. This has enhanced competition and lowered the cost of borrowing.

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.

3. Order-Marking Requirement and Confirmation of Locates Post-Trade

Reg SHO requires broker-dealers to mark all sell orders of any equity security as "long" or "short." This requirement informs prime brokers and executing brokers in the clearance and settlement process as to whether a security that needs to settle is a long or short trade. Further, it enables prime brokers to review whether a security was located prior to the short sale. As noted in Appendix IV of the Report, many jurisdictions currently require that sell orders be marked, and we encourage others to implement these requirements. We believe regulators should require prime brokers to perform daily reconciliations and identify whether short sales of hard-to-borrow securities they process were located by the broker-dealer prior to its order. This process would help enforce the locate requirement and limit naked short selling.

4. Publication of Threshold Securities

Under Reg SHO, a security with persistent fail to deliver positions are categorized as threshold securities.[23] Reg SHO requires that exchanges and other registered market centers publish a daily list of threshold securities. The list informs market participants of securities experiencing persistent fails to deliver and enable them to take extra steps in ascertaining the confirmation of a locate to prevent a failure to deliver securities. Reg SHO also contains a close-out provision for a threshold security that provides market participants with time for a security to clear and settle on its own, or for a market participant to cover its short position. As originally adopted, Reg SHO's requirement that a threshold security that has failed to deliver for thirteen consecutive settlement days be closed-out, prevented market disruptions and short squeezes.[24] We continue to believe that the marketplace derives great value from the daily publication of a threshold securities list and that it enhances the clearance and settlement process.

5. *Pre-Borrowing Securities*

We believe the locate requirement, along with the publication of a threshold securities list, is more effective in reducing fails to deliver without disrupting the market than a pre-borrow requirement. A requirement to pre-borrow a security before entering a trade order would significantly increase borrowing costs to investors to a degree that negatively affects legitimate short selling, and would decrease market liquidity and market efficiency.

From July 21, 2008 to August 4, 2008, the SEC imposed an emergency pre-borrow requirement, which mandated pre-borrowing for short sales of certain financial company securities. During this period,

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[23] A *threshold security* means any equity security for which there is an aggregate fail to deliver position for five consecutive settlement days at a registered clearing agency of 10,000 shares or more, and that is equal to at least 0.5% of the issue's total shares outstanding.

[24] In October 2008, the SEC adopted Rule 204T, a temporary rule that imposes a hard close requirement.

market participants were no longer able to automate their short selling orders. Instead of systematically locating securities and electronically placing trade orders, market participants had to revert to manual trading—a slower and less efficient way of trading. An economic analysis of the effects of the pre-borrow requirements, concluded that they:

- Decreased market liquidity;
- Increased bid-ask spreads of affected securities;
- Reduced certain measures of market quality; and
- Decreased overall market efficiency of trading in the affected securities.[25]

We are not aware of evidence of any benefits resulting from the requirements, and accordingly we believe pre-borrow requirements are inappropriate restrictions on legitimate short selling activity.

6. Close-Out Requirement

While we agree that strict settlement requirements should be included as part of effective short selling regulation, it is essential that adequate time be provided prior to a mandatory close-out to allow the opportunity for a security to clear and settle on its own or for a market participant to have adequate advance notice to cover its short position. A mandatory close-out period that is too short causes market disruptions and short squeezes. In balancing the interests of market efficiency, market liquidity, timely delivery and settlement, we believe regulators should conduct an analysis of clearance and settlement systems. Such analysis should include data from securities depositaries, custodian banks, prime brokers and executing brokers in determining the number of days required after settlement date for clearing participants to settle most trades without market disruption.

In the United States, the vast majority of fails to deliver is closed out within five days after settlement date and more than 70% of all fail to deliver positions are closed out within two settlement days after settlement date.[26] For short sales, just as the SEC acknowledged for long sales, "fails to deliver may occur . . . within the first two settlement days after settlement date for legitimate reasons" such as "human or mechanical errors."

At a minimum, MFA recommends that regulators require market participants to close-out fails to deliver for all securities at the end of trading on the third day after settlement date (trade date + six). The requirement should treat long sales and short sales equally. Such a requirement would allow enough time for the majority of trades to clear on their own without disrupting the efficient functioning of the Continuous Net Settlement ("CNS") systems, such as the CNS system operated by the National Securities Clearing Corporation ("NSCC") and the operations of clearing brokers. Requiring securities that fail to deliver to be closed out at the end of the third day after settlement date would also provide buy-side firms with some time to cover positions and limit the likelihood of a short squeeze. Further, we believe such a rule would better separate trades with legitimate settlement delays from naked short sales.

III. REPORTING OF SHORT SALE INFORMATION

The Report's second principle affirms that "short selling should be subject to a reporting regime that provides timely information to the market or to market authorities." We believe that these objectives

[25] *See Short Selling Activity in Financial Stocks and the SEC July 15th Emergency Order*, Arturo Bris, IMD, European Corporate Governance Institute and Yale International Center for Finance, August 12, 2008.

[26] Regulation SHO Release.

can be best achieved by reporting by prime brokers and clearing brokers, rather than individual investors, reporting short sale information to regulators on a confidential basis. Initially, brokers could provide short position information to regulators confidentially on an aggregate basis. Such a reporting regime would provide regulators with more comprehensive market information and better enable them to respond to any potential manipulation in the securities markets caused by short selling.

As described in Appendix IV of the Report, many regulatory jurisdictions have adopted short sale reporting rules over the past year. Although not uniform, the rules generally require market participants to report short sale information in excess of a threshold level to the appropriate regulatory agency. During their consideration of short selling rules, we encourage Technical Committee members to examine whether short sale disclosure rules in the U.S. and other jurisdictions have been effective in preventing artificial price movements due to "naked" short selling. In this vein, we have suggested that the SEC publicly announce the results of its recent examinations of potential manipulation of securities prices through spreading of false information, and disclose whether the examination and the information reported revealed instances of manipulative "naked" short selling or other related market abuses. In addition, we have encouraged the SEC 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 rulemaking on the results of this review and other relevant facts. Similarly, we urge Technical Committee members to continue to share results of studies that they have undertaken to further inform the policy discussion among market participants, other interested parties, and the public.

A. Reporting by Prime Brokers and Clearing Brokers

We believe reporting by prime brokers and clearing brokers, rather than individual investors, would better achieve the policy concerns of regulators. The SEC, for example, is concerned with the "substantial threat of sudden and excessive fluctuations of securities prices and disruption in the functioning of the securities markets that could threaten fair and orderly markets" and "unnecessary or artificial price movements that may be based on unfounded rumors and may be exacerbated by short selling."[27] Reporting of short sale and short position information by prime brokers and clearing brokers, rather than by individual institutional investors, would provide regulators with more usable, comprehensive short selling information and would better enable regulators to identify and respond to any potential fraudulent short selling activity.

1. Type of Short Information Reported

Reporting of client short sales and short positions by prime brokers and clearing brokers could provide regulators with more complete, top-down information than reporting by individual institutional investors. In the U.S., brokers gather and retain current, aggregate short sale information, including data on locate requirements, fails to deliver and "naked" short sales. Market participants in the U.S. regularly provide order marking information to brokers pursuant to Rule 200(g) of Reg SHO. Prime and clearing brokers in the U.S., for example, could include this information in reports they submit to the SEC, or they could provide the information to the SEC upon request if the SEC has concerns regarding potential manipulative conduct taking place with respect to a particular security.

[27] 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).

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. Short sales and short positions are less useful to determine whether short sales were conducted in a fraudulent manner.

Prime brokers and clearing brokers could report all short sales and short positions, including those below any *de minimis* thresholds. Because prime brokers and clearing 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 than weekly, if required, and already provide data in a more efficient and user-friendly format than current reporting by individual investors. Reporting by individual investors would continue to result in regulators receiving large volumes of short sale and short position information from individual investors that it then must extensively analyze.

Under the alternative reporting regime that MFA proposes, regulators 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 could 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 a regulator 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.

2. Consistency with Existing Reporting Regimes

Reporting by prime brokers and clearing brokers would be consistent with some existing reporting regimes. 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.[28] Member firms report short interest positions through FINRA's Regulation Filing Applications.[29] FINRA then provides 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. The procedures by which brokers aggregate short interest positions of their customer and proprietary accounts and submit short interest reports to exchanges could be adapted to short position reporting.

A system of reporting by prime brokers and clearing brokers could also make use of information already reported by brokers. As noted above, investors in the U.S. are required to report order marking information to brokers under Rule 200(g) of Reg SHO. Moreover, member firms are required under the Order Audit Trail System Rules ("OATS") for Nasdaq-listed securities and the Order Tracking System ("OTS") for NYSE-lised securities, to record and report detailed information of order events to FINRA

[28] *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.

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

and the NYSE, respectively.[30] OATS and OTS reporting already require member firms to capture much of the relevant data with respect to their orders and executions. In addition, broker-dealers currently must submit detailed securities transaction information upon request to the SEC for enforcement and other regulatory purposes through the Electronic Blue Sheet system.[31] Reporting of short sale information by prime brokers and clearing brokers could make use of these and similar requirements and facilities in other jurisdictions.

3. Risk of Public Disclosure

Prime brokers and clearing brokers could report short position information to regulators in a manner that provides them with tools to detect manipulation while reducing the risk of public disclosure of individual investors' proprietary trading information. We strongly believe that public disclosure of short sale information could have the perverse effect of increasing market volatility, being potentially misleading to the public, and causing irreparable harm to the proprietary trading strategies of money managers and harming fund investors, such as pensions, endowments and foundations.

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. If regulators were to adopt a private reporting requirement, we recommend that they also exempt such information from any laws that could require public disclosure of government materials upon request or otherwise. For example, if short position information reported on Form SH in the U.S. were subject to the Freedom of Information Act ("FOIA"), it would create a substantial risk of public disclosure. We have urged the SEC to affirm its intent to assert the applicable exemptions for information submitted on Form SH against any claim filed under FOIA, including with respect to any claim to be determined by a court, and we recommend that regulators consider any similar laws that could limit the efficacy of private reporting.

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 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 throw sand in the gears of capital markets by limiting the free flow of information essential for informed investments and vibrant markets.[32] We are concerned that the public disclosure of detailed short positions would have long lasting negative

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[30] *See* FINRA Rule 7400 Series and NYSE Rules 132A-132C.

[31] Rule 17a-25 of the Securities Exchange Act of 1934.

[32] Such threats also raise questions under U.S. Regulation FD, 17 CFR §243.100 *et seq*.

effects on 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 on 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.[33]

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 irreparable 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 position information by prime brokers and clearing brokers. Initially, short sales and short position information could be provided by brokers to a regulator on an aggregate basis. A regulator could request specific information as to short positions of individual investors if it suspected or became concerned about manipulation of a particular security. As described above, reporting by prime brokers and clearing brokers would provide regulators with enhanced tools to identify manipulative activity on a security-by-security basis. Regulators 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 risk of public disclosure while providing regulators with more comprehensive short selling information.

B. Reporting by Individual Investors

As noted above, we encourage regulators to examine whether short sale disclosure rules in the U.S. and other jurisdictions have been effective in preventing artificial price movements due to "naked" short selling. We further encourage regulators to examine whether prime brokers and clearing brokers could report short sale information more efficiently and at a lower aggregate cost than individual investors.

If regulators deem it necessary to require 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. Specifically, we recommend that reporting rules, among other things:

[33] While these concerns would be reduced in jurisdictions that require disclosure based on an investor's net short sales 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.

- **Mandate that any reporting be only to regulators, be treated as confidential and remain non-public.** Public disclosure of information would result in adverse consequences to investors, issuers, other market participants and the market as a whole.
- Adopt reporting based upon **positions** and not include additional trade reporting.
- Use only a single percentage *de minimis* threshold of 2.0% or higher of a percentage of a class of the issuer's securities. Short sales and short positions below 2.0% are not significant and individual investors should not have to report that information.
- Require reporting on a quarterly basis.

We elaborate on each of these points below.

1. Reporting of Short Sale Positions

We recommend that investors report end of day short positions, and not short sales. Short position-based information is more helpful to regulators in identifying potentially fraudulent short selling activity than transaction-based information. With position-based information, regulators would receive more manageable, streamlined information and could more efficiently review short positions held in a specific security.

2. De Minimis Threshold

We believe any reporting requirements should include a single *de minimis* reporting threshold based on short positions of a percentage of a class of the issuer's securities. Such a single threshold would be consistent with the short selling reporting rules of most jurisdictions. Uniform short information reporting rules across jurisdictions would simplify reporting by investors currently subject to the disparate U.S. and non-U.S. requirements.

We recommend that the *de minimis* reporting threshold of a percentage of a class of the issuer's securities be 2.0% or higher. The current requirement in most jurisdictions of reporting short positions that meet or exceed 0.25%[34] of the issuer's securities 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.

3. Scope of Short Information Reporting

Information reported to regulators should include all cash short positions and exclude synthetic positions, such as over-the-counter derivatives, that do not create or expand a market short position. Synthetic instruments that do not create or expand a market short position would be misleading if reported. Reporting should be designed to capture market short positions of individual securities. For example, parties may enter into an over-the-counter equity derivative transaction, such as a bilateral swap, based on the value of an underlying equity security. Under the terms of the swap, a party would receive payment from a counterparty equivalent to any decrease in value of the underlying security. If the

[34] The FSA has recently proposed to raise the threshold reporting level to 0.50% of a company's issued share capital. *See* FSA Discussion Paper.

counterparty were to hedge its exposure to the swap by taking a short position in the underlying security, that hedging transaction should be reported as a short position. The swap exposure, however, should not be reported as a short position, as it would essentially double-count the short exposure in that underlying security. Furthermore, absent a hedge by the counterparty, the swap arrangement would not create or expand a market short position in the underlying security, and would be misleading if reported.

4. Frequency of Reporting

We recommend that any reporting of short position 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, along with position-based reporting, would alleviate reporting burdens and provide regulators with more meaningful short position information.

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

IV. SHORT SELLING ENFORCEMENT

The Report's third principle asserts that short selling be subject to an effective compliance and enforcement system. MFA and its members share the Technical Committee's deep concerns about the crisis in the global financial markets and strongly support efforts to prevent, detect and punish manipulative conduct.

As described above, we believe reporting by prime brokers and clearing brokers, rather than individual investors, would enhance the ability of regulators to monitor short selling activity and conduct effective surveillance and enforcement programs. Such a reporting regime would provide regulators with more usable, comprehensive short selling information and would better enable regulators to identify and respond to any potential fraudulent short selling activity. In the U.S., brokers gather and retain current, aggregate short sale information, including data on locate requirements, fails to deliver and "naked" short sales. As noted above, market participants in the U.S. also regularly provide order marking information to brokers pursuant to Rule 200(g) of Reg SHO. Prime brokers and clearing brokers in the U.S., for example, could include this information in reports they submit to the SEC, or they could provide the information to the SEC upon request if the SEC has concerns regarding potential manipulative conduct taking place with respect to a particular security.

Prime brokers and clearing brokers could report all short sales and short positions, including those below any *de minimis* thresholds. Because prime brokers and clearing 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 than weekly, if required, and already provide data in a more efficient and user-friendly format than current reporting by individual investors.

We agree with the Technical Committee's recommendation that regulators should have a sufficient level of inspection and investigation authority to conduct oversight of short selling activity. Regulators that do not already have such powers should acquire them as part of any amendments to a jurisdiction's short selling regime. Regulators with existing authority, such as the SEC,[35] should investigate any potential manipulation of securities prices through spreading of false information, instances of manipulative "naked" short selling or other abusive short selling practices,[36] and disclose the results of such investigations. We also encourage regulators to investigate whether any disclosure requirements or temporary short selling prohibitions have been effective in preventing any market manipulation.

In connection with their investigation authority, regulators should conduct fact-finding investigations to determine what level of "naked" short selling has occurred in their jurisdiction and make public the results of the investigations. In this vein, we have also recommended to the SEC that we believe it would be beneficial to U.S. issuers and investors for the SEC to provide to the public an analysis of the market impact of Rule 204T[37] as well as a summary of the SEC and FINRA's investigations into broker-dealers' compliance with Reg SHO. Market participants in the U.S. would benefit from meaningful analysis detailing the frequency of non-locates, fails to deliver and the proportion of fails to deliver that are attributable to an exception to Rule 204T and Reg SHO in understanding the extent of any "naked" short selling problem. We believe that international regulators should conduct similar analyses of "naked" short selling and provide the results of their determinations to investors and market participants. These analyses would help restore confidence in our financial markets and provide quantitative data upon which future regulation can be based.

We support the Technical Committee's recommendation that financial regulators strengthen their cooperation with foreign counterparts and review whether their existing cross-border information sharing arrangements are sufficient to facilitate cross-border investigation. Information sharing arrangements should ensure that any information that is provided to a regulator on a confidential basis remain non-public in the jurisdiction that receives the information. For example, as noted above, information provided to the U.S. government generally may be subject to public disclosure under FOIA. Under U.S. law, however, the SEC is exempted from disclosing to third parties confidential information it obtains from a foreign securities authority in response to a FOIA request.[38] We believe such provisions would most effectively facilitate international sharing of confidential information and avoid potential unintended consequences described above as a result of any public disclosure of short selling information.

V. EXCEPTIONS FOR CERTAIN TRANSACTIONS

We are pleased that the Technical Committee has included as its fourth principle a recommendation that short selling regulation should allow appropriate exceptions for certain types of transactions for efficient market functioning, including *bona fide* hedging, market making and arbitrage

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[35] The SEC has authority to enforce the anti-fraud provisions of U.S. federal securities laws with respect to short selling activity conducted by brokers, investors and other market participants. Both SEC-registered investment advisers and investment advisers not registered with the SEC are subject to these provisions. *See* Section 206 of the Investment Advisers Act of 1940 and rules thereunder.

[36] MFA 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.

[37] *See* SEC Memorandum from the Office of Economic Analysis regarding Impact of Recent SHO Rule Changes on Fails to Deliver, March 20, 2009, available at: http://www.sec.gov/comments/s7-30-08/s73008-107.pdf.

[38] *See* Section 24(d) of the U.S. Securities Exchange Act of 1934.

activities. The Report explains that such activities provide benefits to capital markets and are unlikely to pose destabilizing risks.

While we appreciate that the Report identifies certain investment techniques that involve short selling that do not pose destabilizing risks to markets, we believe that only fraudulent or manipulative short selling is contrary to healthy capital markets. As noted above, short selling serves to enhance price discovery, mitigate market bubbles, increase market liquidity, facilitate hedging and other risk management activities and limit upward market manipulations. We believe that rather than identifying certain types of short selling transactions that are beneficial to markets, regulators should permit short selling generally, subject to appropriate controls as described above. General restrictions on short selling, such as those adopted by the SEC and the FSA in September 2008, are harmful to capital markets and investors, and we strongly urge that regulators not adopt any further prohibitions. Regulators should instead investigate any potential manipulation of securities prices through spreading of false information, instances of manipulative "naked" short selling or other abusive short selling practices, and disclose the results of such investigations.

The Report suggests that regulators consider whether *bona fide* hedging transactions should be exempted from any short position reporting requirements. As noted above, public disclosure of short positions resulting from *bona fide* hedging transactions would be misleading to investors. 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.

Public disclosure of short position information could also have unintended consequences on 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. Public disclosure of short positions might discourage investors from making investments on the long side or engaging in short sale transactions for hedging purposes, reducing investors' ability to manage risk, and decreasing market liquidity and capital formation.

We believe that reporting by prime brokers and clearing brokers, rather than individual investors, to regulators on a confidential basis would eliminate these concerns and provide regulators with more comprehensive market information and better enable them to respond to any potential manipulation in the securities markets caused by short selling. As noted in the Report, under a public disclosure regime, it would be necessary to define any activities exempt from disclosure requirements, including market making, arbitrage, and bona fide hedging. We believe that such a process would be difficult and overly burdensome to both regulators and investors, and for the reasons noted, recommend that regulators instead require private, confidential reporting of short positions.

(Continued on next page)

VI. 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 Technical Committee considers the effects of short selling on capital markets. Should you have further questions or comments, we would be delighted to meet with you or other members of the Technical Committee. If you have any questions or comments, please contact Matthew Newell or the undersigned at (202) 367-1140.

Respectfully submitted,

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