

MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry

WASHINGTON, DC | NEW YORK



September 21, 2008

Via Electronic Mail: coxc@sec.gov

The Honorable Christopher Cox
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Release No. 34-58592 and Release No. 34-58591

Dear Chairman Cox:

On September 18th, the Securities and Exchange Commission took temporary emergency action to prohibit short selling in certain financial companies and to require institutional money managers to report weekly new short sales of certain publicly traded securities on new Form SH. Managed Funds Association (“MFA”)¹ and its members share the Commission’s deep concerns about the crisis in the global financial markets and strongly support efforts to prevent, detect and punish manipulative conduct. We are deeply troubled, however, by the Commission’s unprecedented actions in response to the crisis. Specifically, MFA is concerned that the Commission’s emergency orders, Release Nos. 58591 (the “Disclosure Order”) and 58592 (the “Prohibition Order,” and, with the Disclosure Order, the “Orders”), will have the adverse effects of further reducing liquidity and increasing volatility in the capital markets and, because the orders fail to address the underlying reasons for the current crisis, will not achieve any benefit.

As managers of alternative investment vehicles, our members share the Commission’s concerns with respect to investor protection and the orderly functioning of markets. As participants in a highly interconnected financial system, our members are entirely dependent on overall systemic stability and the health of the financial firms with whom they trade and from whom they borrow. To be absolutely clear, the widespread failure of financial firms would be an unequivocal disaster for “hedge funds.” We recognize that the financial sector is undergoing an extremely stressful period, and believe this is widely and correctly recognized to stem from poor

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 \$2 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

lending, risk management and disclosure decisions made historically by many financial institutions, and not from short-selling activities. We therefore have significant concerns with each Order as currently drafted, as well as with the apparent regulatory philosophy underpinning them. We believe the Orders will have adverse consequences for our capital markets, including increasing volatility and further reducing much needed liquidity and risk management latitude, and will, like the emergency order issued by the Commission in July, ultimately fail to provide any public benefit whatsoever. The Orders are directly contrary to the U.S. government's historical admonition to other governments during previous global financial crises to maintain open, fully functioning markets. The markets can operate effectively only if investors both domestically and abroad have confidence in the stability of the "rules of the game" that all market participants are obliged to follow.

We urge the Commission to make several amendments to the Orders to address fundamental concerns with the current versions. We also request that the Commission clearly state the risks the Orders are intended to address and the goals they are intended to achieve, so that all parties may have a productive dialogue about an appropriate response. We further ask the Commission not to extend either Order beyond its announced expiration date. If the Commission wishes to consider further regulatory action, it should do so only after conducting a thorough and careful rulemaking process that provides an opportunity for public consideration and comment, as was done with the process that led to the adoption of Regulation SHO and Regulation NMS.

Requests for Amendments

Disclosure of detailed shorting positions should not be publicly disclosed

MFA and its members understand the Commission's desire for additional information about short selling activities during this period of crisis to help the SEC fulfill its role of market oversight and prevent and detect any manipulative conduct. These concerns could be addressed adequately though disclosure to the Commission and do not necessitate public disclosure of detailed short positions. We therefore strongly urge the Commission not to make public any information obtained pursuant to the Disclosure Order.

Public disclosure of detailed short positions of institutional money managers will likely have the perverse effect of *increasing* market volatility for a host of reasons, including: other market participants may choose to mimic the short-selling activity of investment professionals, causing share prices that have plummeted to fall further still; in other cases, market participants may take advantage of knowledge of widely held short positions to "squeeze" those positions, causing a temporary and artificial spike in those positions' prices; managers may abruptly liquidate both long and short positions in order to minimize the risk of destructive disclosure; and severe "sector rotations" in which some sectors that abruptly rise in value due to temporary restrictions on shorting cause sharp sell-offs in other sectors (such as what befell energy stocks in July and August). Disclosure of detailed short positions may also be misleading to the public as people may view all short positions as indicating a negative view about a company even though many reported positions will simply be hedging positions that are part of a manager's risk management strategy. Public disclosure, even if only temporary, also does irreversible 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 as outlined above, but also to reverse engineer the trading strategies themselves.

We understand the Commission has amended the Disclosure Order to include a two-week lag period prior to the Commission making information on Form SH publicly available.² While this proposed amendment would give all parties more time to consider the implications of public disclosure of Form SH data, we do not believe that it adequately addresses the above concerns. We believe that the detailed disclosure required under the Disclosure Order if made public at any point in time would still engender (on only a slightly delayed basis) the adverse market consequences outlined above, and would still fully permit other market participants to unfairly reverse engineer the proprietary trading strategies of a money manager. In the absence of any demonstrated policy reason for public disclosure of Form SH, we urge the Commission to amend the Disclosure Order to provide for Form SH to be disclosed only to the Commission, and for the Commission to keep such information strictly confidential. To the extent that the Commission believes public disclosure of short interest would provide some benefit, the Commission could amend the Disclosure Order to provide for public disclosure only of aggregated short positions that are not specific to individual market participants.

Exception from Prohibition Order for bona fide hedging transactions

Short selling is an essential component of a wide range of bona fide hedging strategies that enables investors to provide liquidity to the financial markets. The Prohibition Order would undermine the bona fide hedging strategies that are a critical risk management tool of investors and enable investors to make investments on the long side of the market.

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. As a result of the Prohibition Order, investors would not be able to adequately protect themselves by hedging their exposure and, therefore, potential convertible bond investors will likely refrain from investing. The ultimate result will be that companies, particularly distressed companies, will lose an important potential source of capital. Other bona fide hedging strategies that will be similarly affected by the Prohibition Order include selling short the underlying security of options, warrants or other derivatives that provide a long exposure to individual securities or a basket of securities.

As noted in the Prohibition Order, the Commission is concerned with possible artificial price movements based on unfounded rumors regarding the stability of financial institutions and other issuers exacerbated by “naked” short selling. These concerns are not implicated when investors use short selling as a bona fide hedging strategy in connection with long positions in order to reduce risk to their overall portfolios.

In addition, the Prohibition Order may have the unintended consequence of further destabilizing certain financial institutions the Order is designed to protect. Certain market participants are exposed to financial institutions through derivatives transactions and prime brokerage relationships. These market participants frequently hedge their exposure to these companies through shorting their stock. As a result of the Prohibition Order, these market

² Release No. 34-58591A.

participants will be motivated to reduce or eliminate trading with such companies and move balances and positions that create the exposure, resulting in increased liquidity pressures on these dealers.

The inability of investors that are not market makers to engage in hedging transactions also raises significant concerns regarding the fundamental fairness of the prohibition as currently constituted. First, the prohibition precludes numerous investors from being able to manage the risks of investment positions currently held, which were acquired based on a previous understanding that the investor would be able to hedge the risks associated with these instruments. The inability to hedge the risks associated with products already purchased will lead to a significant decline in the value of these products. Changing regulations in a manner that causes harm to investors with respect to contracts already entered into acts as a retroactive change in law in a way that violates fundamental concepts of fair government regulation. Moreover, the exceptions from the prohibition that are available to certain dealers would create a fundamentally unfair disparity in the marketplace as only one group of market participants would have the ability to manage their risks through hedging transactions. All market participants should be given a level playing field by ensuring that they all have the ability to hedge the risks associated with their legitimate investment strategies.

In light of the adverse consequences if investors are unable to protect against risk from their long investments and the lack of risk posed by bona fide hedging, we request that the Commission amend the Prohibition Order to provide the following exception from the prohibition on short selling Included Financial Firms:

The requirements of the Order shall not apply to any short sale in any publicly traded security of an Included Financial Firm effected by an institutional money manager subject to the requirements of SEC Release Nos. 58591 or 58591A as part of its bona fide hedging activities related directly to hedging long exposure to such Included Financial Firm arising from (i) options, warrants, convertible securities, index products or other derivatives held by such institutional money manager or (ii) equity interests held by such institutional money manager in the target of an announced acquisition by such Included Financial Firm.

Conclusion

MFA and its members share the Commission's deep concerns about the crisis in the global financial markets and strongly support efforts to prevent, detect and punish manipulative conduct. We are deeply concerned, however, about the adverse consequences that are likely to result from the implementation of the Disclosure Order and the Prohibition Order. We believe the Disclosure Order will lead to increased market volatility and unfairly jeopardize the proprietary trading strategies of managers, to the detriment of their clients and investors. We believe the Commission's desire for information about short selling would be more appropriately addressed through disclosure to the Commission and not to the public. We believe the Prohibition Order will not achieve any of its intended benefits, but instead will lead to increased volatility and a reduction in liquidity to our capital markets as investors who are unable to adequately manage risks associated with long positions will be unlikely to invest in those positions. Moreover, the Prohibition Order raises serious concerns about fundamental principles of fairness as it acts as a retroactive change in law with respect to a variety of existing investment products whose value will be significantly impaired by the lack of ability to hedge risks

The Honorable Christopher Cox
September 21, 2008
Page 5 of 5

associated with those products. The Prohibition Order would also give a fundamentally unfair advantage to one set of market participants, dealers who act as market makers, as they will be the only persons permitted to hedge risks associated with their investment activities.

We appreciate the opportunity to provide comments to the Commission on these important issues. If we can provide further information or be of assistance to the Commission as it considers these comments or other matters related to the Orders, please do not hesitate to contact us at (202) 367-1140.

Respectfully submitted,



Richard H. Baker
President and Chief Executive Officer

cc:

The Honorable Luis A. Aguilar
SEC Commissioner
The Honorable Kathleen L. Casey
SEC Commissioner
The Honorable Troy A. Paredes
SEC Commissioner
The Honorable Elisse B. Walter
SEC Commissioner