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

August 14, 2011

Via Electronic Mail

Steven Maijoor
Chair
European Securities and Markets Authority
103 Rue de Grenelle
75007 Paris
France

Dear Chairman Maijoor:

On behalf of Managed Funds Association ("MFA")[1] and its members, I am writing to express our disappointment over the decision of several competent authorities and the European Securities and Markets Authority's ("ESMA") decision to implement or extend restrictions or bans on short selling. We, along with market authorities, are deeply concerned about the current crisis in the global financial markets and strongly support efforts to reinstate confidence in those markets. We appreciate that competent authorities are closely monitoring financial securities and considering possible measures to enhance investor confidence and market stability. But we are disappointed to learn that some authorities have decided to impose short selling bans in their respective countries. It is in this regard, that we write to urge you to consider the past experience when market authorities have implemented short sale restrictions. As demonstrated by empirical evidence from short sale restrictions in 2008, the restrictions had a detrimental effect on markets and investor confidence. We respectfully urge you and members of ESMA to refrain from or reconsider implementing a short sale ban and to consider alternative measures to short sale restrictions, as evidence shows that such bans have proven to be more harmful than beneficial to markets.

I. Executive Summary

We urge competent authorities to reconsider implementing a short sale restriction as past experience with short selling restrictions show that:

- Restrictions are counterproductive, further deteriorate investor confidence and increase volatility.

[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 $2.0 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

600 14th Street, NW, Suite 900 | Washington, DC 20005 | 202.730.2600 | Fax 202.730.2601 | www.managedfunds.org

- Restrictions impair the ability of investors to manage risk, leading many to sell additional securities to balance their portfolios.

- Restrictions freeze the ability of financial institutions to raise capital through convertible bond and convertible preferred security issuances by preventing investors to purchase the convertible products and hedge the risk with offsetting short sales.

- The absence of a consultation period undermines investor confidence and creates market uncertainty with respect to interpretive guidance and compliance efforts.

II. Comments

A. Past Experience with Short Sale Restrictions

Notwithstanding the laudable goal of restoring confidence in the markets, the use of a short selling restriction as a policy tool will likely undermine the confidence of investors who may view it as a sign of desperation or interpret it as an indication of the severity of a financial institution's circumstances. In fact, multiple studies on the U.S.'s Securities and Exchange Commission ("SEC") Order Halting Short Selling of financial securities indicate that the ban actually further deteriorated investor confidence in financial securities and was followed by steep selling by institutional investors that owned financial securities. In retrospect, the chairman of the SEC at the time has publically stated that "it was the biggest mistake of his tenure."[2]

Up until the SEC Order Halting Short Selling of certain financial securities, the restricted financial securities were actually performing better than the market.[3] Subsequent studies show that the SEC Order Halting Short Selling did not prevent any price declines, but severely degraded the market quality of the subject securities as it:

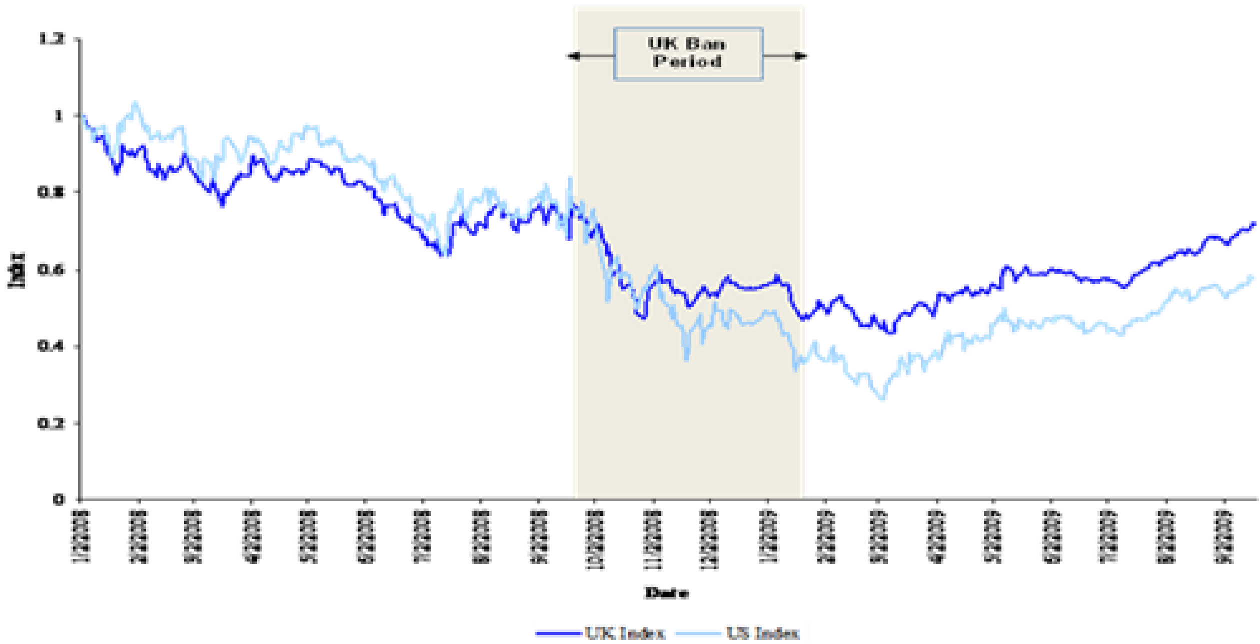
- Failed to stop the steep price declines (see chart below on stock declines during the U.S. and UK short sale bans);
- Increased volatility;
- Impaired capital raising for the subject securities;
- Decreased market efficiency;
- Significantly decreased trading volume and market liquidity; and
- Increased bid-ask spreads from a "normal" average of 17 basis points in 2008 to 60 basis points by October 8, 2008.[4]

[2] SEC Chief Defends His Restraint, The Washington Post, December 24, 2008.

[3] Examining the Wake of the Short Sale Restriction, AES Analysis, Credit Suisse, Oct. 13, 2008.

[4] *Id.*; Shorting Financial Stocks Should Resume; Shackling Short Sellers: The 2008 Shorting Ban, Boehmer, Jones and Zhang, November 18, 2008; The Undesirable Effects of Banning Short Sales, Abraham Lioui, EDHEC Business School, Risk and Asset Management Research Centre, April 2009; The Blame Game: What Caused Spreads to Widen, AES Analysis, Credit Suisse, Nov. 12, 2008; *and* The Effect of Short-selling Restrictions on Liquidity: Evidence from the London Stock Exchange, Matthew Clifton and Mark Snape, Capital Markets Cooperative Research Centre, Dec. 12, 2008.

U.S. Financials Index vs. UK Financials Index
2008 – September 2, 2009



Source: Bloomberg

Summary of short-selling bans

	US	UK
Start date	9/19/2008	9/18/2008
End date	10/8/2008	1/16/2009
Sector	Financial services	Financial services
Number of equities[5]	799	34

Source: Oliver Wyman

A ban on short sales, even when temporary, harms liquidity and efficiency and disrupts markets. Short sale bans undermine the *bona fide* hedging strategies that are a critical risk management tool of investors and enable them to make investments on the long side of the market. The majority of short sales are paired with a similar long trade as part of a market neutral or hedging strategy. It is estimated that only 0.7% of all hedge fund strategies are dedicated solely to short selling.[6] The remaining 99.3% of strategies involve shorting as part of a hedging strategy or risk-management tool. Investors who are not able to hedge or manage the risk of their long positions through short sales, or are concerned about their future ability to do so, are faced with the difficult decision of reducing their long positions by selling into an already

[5] Number of equities is the number included at the beginning of the ban on short selling. Some of the equities initially included ceased to be traded for various reasons during the ban period (*e.g.* bankruptcy, merger, privatization, etc.).

[6] Ticking off the Shorts, AES Analysis, Credit Suisse, Apr. 23, 2009.

600 14th Street, NW, Suite 900 | Washington, DC 20005 | 202.730.2600 | Fax 202.730.2601 | **www.managedfunds.org**

declining market. Thus, a ban on shorting impairs capital formation, reduces purchasing overall, and possibly contributes to more selling, thereby lowering volume and liquidity with the already mentioned negative consequences. We believe a short sale restriction also undermines confidence in financial markets, particularly from the broad base of global institutional investors and traders who are large scale, daily participants in the markets.

In addition, the SEC Order Halting Short Selling froze the ability of financial companies, and eventually all companies, to raise vital capital through convertible bond and convertible preferred security ("Convertibles") issuances.[7] A short sale ban restricts the ability of investors to buy Convertibles, because investors are not able to hedge their risk through an off-setting short position in the related equity. As a consequence, when buyers are not able to buy Convertibles, holders of Convertibles are left with illiquid positions that sink in value. A short sale ban also limits the ability of banks to raise needed capital through new issuances of Convertibles. Consequently, without a *bona fide* hedge exemption to the SEC Order Halting Short Selling, investors in outstanding convertibles were unable to properly hedge, suffered losses, and were unable to continue to purchase Convertibles and provide financing to these companies without the ability to hedge these investments. The SEC Order Halting Short Selling also destabilized the option value of all Convertibles due to the uncertainty of regulatory activity by causing a significant decline in the option value of Convertibles issued by financial services companies—in some cases by one-third or more since the order became effective. Thus, to limit harming the ability of banks to raise necessary capital through Convertibles, we urge competent authorities implementing a short sale restriction, at a minimum, to allow a person to count long positions in Convertibles towards total net short exposure.

Studies from 2008 show that other measures restricting short selling are just as harmful as bans. The empirical data on the SEC Pre-borrow Order requiring all market participants to pre-borrow shares before shorting ("SEC Pre-borrow Order") showed that short selling activity in financial stocks leading up to the SEC Pre-borrow Order for the period January 1, 2008 through July 15, 2008 (the "sample period") found:[8]

- The short selling level in the 19 securities subject to the SEC Pre-borrow Order ("G19" securities) for the sample period, on average at 12%, was lower than in comparable U.S. financial institutions, on average at 13%.[9]

- There were more convertible bond issuances for G19 securities over the sample period than for comparable firms. Many investors hedge convertible bond investments by

---

[7] SHORT SALE BAN WALLOPS CONVERTIBLE-BOND MARKET, WSJ, September 26, 2008. Prior to the SEC Order Halting Short Selling the estimated issuance of Convertibles for 2008 was about $60 billion, of which $39 billion was issued by financial companies.

[8] *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 (hereinafter "July 15th EO Study").

[9] The author notes that the difference is significant at the one-percent level.

shorting the underlying firm's stock. Consequentially, convertible bond issuances were found to be a significant determinant of shorting activity during the sample period.

- The negative returns of G19 securities cannot be attributed to short selling activities. In fact, non-G19 securities were shorted more heavily both in 2007 and 2008.

In addition, SEC staff, in its analysis of short selling activity during the first weeks of September 2008, found that:

- Episodes of extreme negative returns were not the result of short selling activity, but from selling activity by sellers who owned the stock (*i.e*., long sellers).

- Short selling is higher during periods of extremely positive returns than in periods of extreme negative returns. The findings indicate that an important fraction of short sellers are contrarian traders, meaning that they tend to sell short when prices are high.[10]

Since the financial crisis of 2008-2009, the SEC has implemented measures to provide investors with information on the aggregate level of short sales. Current U.S. data show that short sales are at a low level.[11]

B. The Lack of a Public Consultation Creates Greater Market Uncertainty

Finally, we wish to raise a related, but separate issue with regard to these actions. Based on press reports, we understand that competent authorities discussed taking action to restrict short sales under the auspices of ESMA, and they announced their decisions late in the day on August 11, 2011. MFA appreciates that in emergency situations, it is sometimes necessary for regulators to take immediate action without the benefit of public consultation. We do not believe that such emergency action was justified in these circumstances. Markets depend on investor confidence and certainty. As investors, we respectfully suggest that actions taken precipitously and without the benefit of public consultation, undermine, rather than bolster, investor confidence. The lack of an opportunity for public consultation means that regulators were forced to make decisions with, at best, limited opportunity to obtain market intelligence.

Moreover, such precipitous actions make it difficult for investors and other market participants to manage their investment activities thoughtfully under predictable circumstances. When competent authorities issue regulations with far-reaching implications for market participants and those regulations take effect immediately, there is no opportunity for the competent authorities to issue interpretive guidance to assist market participants with compliance efforts.

---

[10] OEA Memorandum from Daniel Aromi and Cecilia Caglio through James Overdahl to Chairman Christopher Cox, dated December 16, 2008, on the analysis of short selling activity during the first weeks of September 2008 (hereinafter "OEA Dec. 16 Memo to Chairman").

[11] Short Selling Declines at Big Board, WSJ, August 10, 2011.

For example, the current short sale orders by competent authorities have created a great deal of market uncertainty and disruption with respect to the trading of broad-based indices, including futures, which consist of one or more restricted securities. Investors commonly short broad-based indices as a risk management tool. Many are finding that under the short sale restrictions, this is no longer available as a way for investors to manage portfolio risk. Especially in a time of extreme market volatility, the loss of the ability to hedge market risk is causing great harm to investors and forcing investors to make additional sales of securities in order to rebalance their investment portfolios and limit market risk. While we do not agree with the decision of competent authorities to impose a short selling ban, we urge that clarification be provided excluding the trading of broad-based indices; or at a minimum, if authorities intend to include indices that they limit the restriction to indices where financial securities make up a substantial threshold percent of the index.

Again, we do not believe that the recent market pressures justified taking summary action under these circumstances, and are concerned that the restrictions will create greater market uncertainty, disruption and instability. We support sensible regulation and reasonable fiscal and monetary policies, which we believe are the answers to returning efficiency and stability to the markets.

III. Conclusion

As managers of alternative investment vehicles, our members share the competent authorities' concerns with respect to investor confidence, 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. We commend ESMA for stating as follows:

> ESMA wants to emphasise the requirements in the Market Abuse Directive (MAD) referring to the prohibition of the dissemination of information which gives, or is likely to give, false or misleading signals as to financial instruments, including the dissemination of rumours and false or misleading news. European competent authorities will take a firm stance against any behaviour that breaches these requirements and ESMA will support national authorities to act swiftly against any such behaviour which is clearly punishable.[12]

MFA condemns in the strongest possible terms any fraudulent or manipulative market activity, whether on the long or the short side. But we respectfully disagree with the notion that banning or substantially restricting short sales is an effective means for restoring market stability and public confidence.

To be absolutely clear, the widespread failure of financial firms would be an unequivocal disaster for "hedge funds." By way of example, the collapse of Lehman Brothers (USA) and Lehman Brothers International (Europe) caused substantial financial harm to many hedge funds.

[12] ESMA Public Statement, 2011/266, August 11, 2011.

We recognize that the financial sector is undergoing an extremely stressful period. We therefore have significant concerns with the implementation of a short sale restriction, especially given our recent experience with such efforts, and respectfully urge ESMA and members of ESMA to refrain from implementing a short sale restriction.

* * * * *

MFA would be pleased to discuss this matter with you or your staff further. Please do not hesitate to contact Stuart J. Kaswell (SKaswell@managedfunds.org) or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Richard H. Baker

Richard H. Baker
President and CEO