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

December 23, 2008

Christine Kung
Securities and Futures Commission
8th Floor, Chater House
8 Connaught Road Central
Hong Kong

Re: International Organization of Securities Commissions Technical Committee Short Selling Task Force

Dear Ms. Kung:

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

The U.S. Securities and Exchange Commission ("SEC" or "Commission") recently adopted two interim final temporary rules relating to short selling in response to concerns over sudden fluctuations in securities' prices. Rule 204T requires market participants to deliver a security on a long or short sale by settlement date or immediately close-out the position.[2] Rule 10a-3T requires certain institutional investors to report short sale and short position information to the SEC on a confidential basis.[3] The comments below are based on similar comments MFA recently submitted to the SEC in response to these two rulemakings.[4]

[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] Amendments to Regulation SHO, SEC Release No. 34-58773 (Oct. 14, 2008), 73 FR 61706 (Oct. 17, 2008) ("Regulation SHO Release").

[3] 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) ("Disclosure Release").

[4] *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.

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.

In addition, 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.

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.

II. NAKED SHORT SELLING

The Task Force requests comment on whether short selling regulation should prohibit naked short selling. The Task Force in its email describes "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." MFA as a policy matter does not condone naked short selling where an investor has not through the "locate" process confirmed on trade date the general availability for delivery of the particular stock on settlement date.

As a first step in reviewing "naked" short selling, we suggest that regulators 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

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[5] Statement of Securities and Exchange Commission Concerning Short Selling and Issuer Stock Repurchases, SEC Release 2008-235 (Oct. 1, 2008).

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 as well as a summary of the SEC and the Financial Industry Regulatory Authority's investigations over the last several years on broker-dealers' compliance with Reg SHO. Market participants 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.[6] 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.

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.[7] 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.

III. APPROPRIATE REGULATORY CONTROLS

We believe appropriate regulatory controls for short selling include:[8]

- 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;

[6] 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*. ("Reg SHO"). 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 Task Force are fully familiar with the SEC's terminology.

[7] 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 July 15th Emergency Order 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.

[8] 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.

- 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.

We believe that the Reg SHO short selling framework has been highly effective in substantially reducing fails to deliver without disruption to the market.[9] Any future regulation of short selling should continue to limit disruption to the market and not interfere with timely and best execution of trades. Reg SHO also created operational efficiencies that contributed to tighter bid-ask spreads and more liquid markets. To assist the Task Force in developing principles for the regulation of short selling, we offer a discussion of Reg SHO as a case study and model for international regulatory standards.

A. Regulation SHO

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 while minimizing naked short selling and failures to deliver. The SEC engaged in studies, investigations and reviews of the efficacy of the "Uptick Rule"[10] before concluding that it was ineffective and repealing it. In particular, the SEC determined that the continued sophistication of trading activities, for example through decimal pricing, high-volume trading and sub-penny quotes, reduced the efficiency of the Uptick Rule. We believe these factors continue to apply and would make an uptick or similar rule ineffective. 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. 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

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

[10] Former SEC Rule 10a-1 provided that, subject to certain exceptions, a listed security could be sold short (A) at a price above the price at which the immediately preceding sale was effected (plus tick), or (B) at the last sale price if it was 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.

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.[11] For an easy-to-borrow security, many buy-side firms employ an automated trading system that electronically locates and places trade orders. For a hard-to-borrow security, the general practice is for a buy-side firm to manually confirm location of the security before placing the trade order to minimize the likelihood of a failure to deliver the security. Many prime brokers built in the added step of performing daily reconciliations, identifying short sales that they process with respect to whether a locate was performed in advance of the trade. Such practices instill discipline into the trading process and reaffirm the locate process.

2. 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. 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.

3. Publication of Threshold Securities

Under Reg SHO, a security with persistent fail to deliver positions are categorized as threshold securities.[12] 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.[13] 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.

[11] 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.

[12] 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.

[13] As noted above, the SEC recently adopted Rule 204T, a temporary rule that imposes a hard close requirement.

4. 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 a degree that negatively affects legitimate short selling, and would decrease market liquidity and market efficiency.

The SEC instituted an emergency pre-borrow requirement, which mandated pre-borrowing for shorting select financial company securities (the "Pre-borrow Emergency Order"). The Pre-borrow Emergency Order was in place from July 21, 2008 through August 4, 2008. 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 impact of the Pre-borrow Emergency Order,[14] shows that the Pre-borrow Emergency Order:

- Decreased liquidity;
- Increased bid-ask spreads;
- Deteriorated market quality; and
- Decreased market efficiency.

As a result, it became much more difficult for investors to trade without having a severe market impact, and prices became less transparent.

5. Close-Out Requirement

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.[15] 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). This 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

[14] *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.

[15] Regulation SHO Release.

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.

IV. REPORTING OF SHORT SALE INFORMATION

We strongly recommend that prime brokers and clearing brokers report short sale information, rather than individual investors. Such a reporting regime 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.

Many regulatory jurisdictions have adopted short sale reporting rules over the past several months. 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 its consideration of the regulation of short selling, we encourage the Task Force 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 have suggested that the SEC communicate to the public 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 Task Force 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.

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:

- 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.
- **Mandate that any reporting be only to regulators, be treated as confidential and remain non-public.** Public disclosure of information would likely result in adverse consequences to investors, issuers, other market participants and the market as a whole.

We elaborate on each of these points below.

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."[16] 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. 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 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.

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 sales and 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. 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 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 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.

[16] Disclosure Release.

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.[17] Member firms report short interest positions through FINRA's Regulation Filing Applications.[18] 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 sale and short position reporting to the SEC.

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 and the NYSE, respectively.[19] 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.[20] 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 sale and 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.

Under Rule 10a-3T, information reported to the SEC will only remain non-public to the extent permitted by law. As a result, information submitted could be subject to the U.S. Freedom

[17] *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.

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

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

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

of Information Act ("FOIA"), creating a significant risk of public disclosure.[21] We understand that media organizations have already filed numerous blanket FOIA requests for reported short sale information. The SEC cites two exemptions from FOIA under which it has authority to initially withhold this information.[22] We have strongly urged the SEC to assert these exemptions against any claim filed under FOIA, including with respect to any claim to be determined by a court. We request that regulators continue to keep any reported information confidential.

If a regulator publicly discloses shorting information, it probably would disadvantage 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 the SEC were to require public disclosure of short sales or short positions. The risk of public disclosure could cause investors with billions of dollars of assets to withdraw capital and further disrupt already stressed capital markets. 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.[23] 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.

The risk of public disclosure of short sale and 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. As described above, 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, and result in reduced market liquidity and capital allocation.

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

[21] *Cf.* Section 24(d) of the Exchange Act, providing an exemption from FOIA for certain material obtained by the SEC from foreign securities authorities.

[22] Disclosure Release, page 24. Exemption 4 is for trade secrets or privileged or confidential commercial or financial information obtained from a person. Exemption 8 is for matters contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions.

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

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, 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 sales and 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 would further encourage regulators to examine whether prime brokers and clearing brokers could more efficiently report short sale information, rather than individual investors. If regulators determine to require individual investors to report short sale information, any rules that are adopted should account for the operational burdens incurred by ongoing reporting obligations, and be designed to minimize the compliance costs to investors. Reporting of short sale information should be position-based, rather than transaction-based, and be no more frequently than on a quarterly basis. In addition, for the reasons described above, information reported to regulators should be on a confidential basis and remain non-public.

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 sales or 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 (although not the U.S.). 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 sales and short positions that meet or exceed 0.25% 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*.

3. Scope of Short Information Reporting

Information reported to regulators should include all cash short sales 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 short sales and 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 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 sale. The swap exposure, however, should not be reported as a short sale, 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 sale information be quarterly. More frequent filings, such as on a 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 comprehensive short sale information.

(Continued on next page)

V. CONCLUSION

MFA welcomes the opportunity to further discuss any of the recommendations made above, and we would also be pleased to respond to any additional inquiries as the Task Force 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 Task Force. If you have any questions or comments, please contact Jennifer Han, Matthew Newell, or the undersigned at (202) 367-1140.

Respectfully submitted,

Stuart J. Kaswell
Executive Vice President and General Counsel

John G. Gaine
President Emeritus and Special Counsel,
International Affairs

cc: Mr. Martin Wheatley, Chairman, IOSCO Short Selling Task Force