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

October 9, 2009

Via website www.sfc.hk

Mr. Martin Wheatley
Securities and Futures Commission
Chater House
Connaught Road Central 8
8th Floor
Hong Kong

Re: **Consultation on increasing short position transparency**

Dear Mr. Wheatley:

Managed Funds Association ("MFA") welcomes the opportunity to provide comments to the Securities and Futures Commission ("SFC") in response to its Consultation Paper on increasing short position transparency (the "Consultation Paper").

MFA is the voice of the global alternative investment industry. Its members are professional alternative investment managers, including managers of hedge funds, funds of funds, hybrid funds (such as 130/30 funds) and managed futures funds, as well as industry service providers. Established in 1991, MFA is a key source of information for policy makers and the media about the alternative investment industry and a 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 members use a broad variety of different investment strategies and techniques, including short selling. Many MFA members actively trade in Hong Kong and the Asian markets and have considerable personnel and resources located in Asia. MFA is headquartered in Washington, D.C., with an office in New York.

EXECUTIVE SUMMARY

MFA and its members share the SFC's concerns about the crisis in the global financial markets and strongly support efforts to prevent, detect and punish manipulative conduct. In the aftermath of this volatile period, it is important that policy makers adopt measured responses that will enhance market confidence and lead to greater market stability. We strongly believe market confidence and stability are best promoted by regulatory measures

that are based on rigorous economic analysis that demonstrates the benefits to the markets and fully takes into account the risk of adverse behavioural changes. We welcome the SFC's statement that it is not seeking to discourage legitimate short selling activity by increasing transparency on short positions, and that it recognises that legitimate short selling activity is beneficial to the operations of the market by increasing efficiency and liquidity[1].

As described below, while we support the goal of increasing the level of information on short selling available to the SFC, the SFC should examine the data currently available to it as a result of the transactional reporting requirement under Section 171 of the Securities and Futures Ordinance, and determine whether an additional reporting requirement would provide useful and beneficial information.

We are particularly concerned that the public disclosure of short positions could increase market volatility, restrict price discovery and preclude investors from performing critical risk management functions. For this reason we welcome the SFC's suggestion of an approach based on private reports to the SFC, rather than public disclosure to the market. In particular, we consider that a requirement for individual investors to publicly disclose their short positions would have a significant adverse effect. Additionally, the studies of the effects of the recent short selling bans[2] show that last year's unusual volatility with respect to financial stocks was due primarily to investors with net long positions selling off their long positions to reduce their exposure, out of concern about the increasingly negative financial news regarding the financial services sector.

In summary, we recommend:

- Any disclosure to the SFC should be non-public and fully protect the confidentiality of the information. Public disclosure of information would result in adverse consequences to investors, issuers and other market participants.

- Reporting should be based on a de minimis reporting threshold for private reporting to the SFC of at least 0.5%. Short positions below 0.5% are not significant and investors should not have to report that information. Moreover, limiting disclosure to more significant positions permits the SFC to more accurately assess risks rather than being inundated with data.

- If there is evidence available that public disclosure is necessary and beneficial, the SFC should only make available to the public aggregated anonymised data on short selling using the information privately reported to it. Such anonymised disclosure

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[1] Paragraph 5 of the Consultation Paper

[2] Credit Suisse, Examining the Wake of the Short Selling Restriction, Market Commentary, Oct. 13, 2008.

would mitigate some of the risks associated with public disclosures that identify individual investors, although many of those risks would still remain.

INTRODUCTION

The negative impact of short selling bans on global equity markets has been well documented and supported by a range of parties including market participants and academics. For example, bans on selling short financial stocks in the US and UK last fall had materially negative impacts on liquidity and bid-ask spreads while failing to have meaningfully positive impacts on price declines and volatility.

The available data also indicates that requirements for public disclosure have also had materially negative impacts. For example, in the period after short selling bans the US regulatory regime did not include a provision for public disclosure of short interest in financial stocks while the UK regime did include such a provision. In this same period, the metrics of market efficiency and stability in the US performed significantly better than they did in the UK. Liquidity in affected stocks was better in the US and bid-ask spreads were significantly tighter. While there are other variables that would affect the relative performance of such metrics we believe that the less efficient and stable markets in the UK were to a large part as a result of diminished market participation by short sellers. While increased information flow is important for regulators to be able to ensure market stability any short selling disclosure regime should be designed such that it does not implicitly discourage participation in equity markets.

Please see the charts attached at the end of this letter for further information. The charts set out the comparative performance of US and UK financial stocks over the past year, and illustrate the points made above.

RESPONSES TO THE SFC'S QUESTIONS

1. **Is the use of close out indicators an appropriate method to enhance transparency of short selling in the cash market to the SFC. Please provide reasons.**

2. **If you believe the use of close out indicators can be adopted, how can we address the limitations that are set out in paragraphs 13 and 14?**

While the use of close out indicators would provide the SFC with real time information, it would cover only on-market transactions, and so would give only limited additional information about a market participant's short selling activity. In addition to the limited benefits, this approach is also likely to prove expensive for market participants to implement.

Instead, we would support the implementation of a private reporting regime, as discussed further in our response to question 8 below.

3. **Should derivatives (both exchange traded and off-exchange transactions) be included in the short position reporting requirements? Please provide reasons.**

We do not consider that derivatives should be included in the short position reporting requirements. The inclusion of derivatives in the reporting requirements would increase the complexity of the calculations required to determine a firm's net exposure, and would significantly increase the burden to comply with the disclosure obligation, with resulting costs and compliance implications for market participants.

In addition, the inclusion of derivatives would require careful analysis of the types of derivatives which would be appropriate for inclusion in the calculation of a net short position, to avoid confusion over the basis of the calculation and to avoid deluging the SFC with complex information which would be time-consuming to interpret. In particular, derivatives are used for many different purposes including hedging strategies, and it is not clear whether aggregating the different types of exposure may result in multiple counting.

4. **If derivatives are included, which (if any) of the alternatives in paragraph 21 above is the most appropriate? Are there any other practical alternatives? Please provide reasons.**

5. **If any one of the approaches in paragraph 21 is adopted, should those derivatives be limited to ones that create direct exposure to the stock of the listed company? If so, what are the products that should be included (e.g., do you have any views on whether convertibles and other exchangeables should be included?) How should the definition of such derivative be crafted? Please provide reasons.**

6. **If derivatives are included, should they be included on a delta adjusted basis? Please provide reasons.**

As stated above, we do not consider that derivatives should be included in any short position reporting requirements.

7. **Should the reporting requirements cover short positions in Designated Securities only rather than in all listed corporations' securities? Please provide reasons.**

We agree that substantial short positions in non-Designated Securities are unlikely to pose systemic risks, because Designated Securities are selected on the basis of liquidity, and it is unlikely that there will be significant shorting of less liquid stocks in OTC transactions.

The Consultation Paper does not currently make any reference to dual-listed securities and the treatment of such shares. We would suggest that any reporting requirements should apply only to issuers whose securities are solely or primarily listed in Hong Kong, to avoid placing

additional burdens on the person making the report where a security is subject to reporting requirements in more than one jurisdiction. We note that CESR, in its recent consultation paper on a pan-European short selling disclosure regime, has recognised the need for such a system, and refers to disclosure being required only in a security's primary market[3].

8. Which of the approaches above (i.e., threshold approach (with initial and subsequent reporting), or periodic reporting (with or without a threshold level) or either the threshold approach or periodic approach with flexibility to tighten the requirements during a contingency situation) would be the most appropriate for short position reporting? Do you have any other suggestions? Please provide reasons.

We would support monthly or bi-monthly reporting above a de minimis threshold. If the SFC decides to implement a regime under which investors would report short positions privately to the SFC, we would support a reporting regime based on a periodic approach with a threshold level, under which short positions above a de minimis threshold would be reported privately to the SFC on a monthly or bi-monthly basis.

A requirement to report all short positions, with no threshold, will not only be administratively burdensome for both the SFC and the persons filing the reports but will also provide the SFC with a volume of information which is un-targeted and unmanageable. Introducing a de minimis threshold will enable the SFC to assess the possible risks without being inundated with data.

In the interests of regulatory certainty and market confidence, we consider that the threshold approach should not be flexible except in clearly defined and exceptional circumstances. As discussed in our response to question 10 below, the SFC should issue clear guidelines setting out any circumstances in which it may require enhanced reporting.

9. If a threshold approach is adopted, what is an appropriate threshold (and subsequent thresholds) for the Hong Kong market? If periodic reporting is adopted, should thresholds (either a percentage of a listed corporation's issued share capital and/or a dollar value amount) apply? If so, what are appropriate thresholds for periodic reporting? Please provide reasons. If you are a broker or custodian, it would be helpful if you could estimate how many of your clients would be required to file reports if the suggested threshold is adopted.

[3] CESR Consultation paper – Proposal for a Pan-European Short Selling Disclosure Regime; paragraph 26: http://www.cesr-eu.org/popup2.php?id=5791

The SFC should consider carefully the level at which any de minimis threshold is set to avoid placing a disproportionate burden on investors. Where the reporting threshold is set too low, it may impose material constraints on investors who do not engage in significant short selling activity. If an investor does not have the resources to invest in the necessary systems to identify net short positions, then it would have to refrain from any trading activity that might generate even small transitory short positions which could exceed the threshold.

We believe that it would be disproportionately burdensome to require all investors to build systems to cope with this extensive and complex reporting requirement for the stocks within the scope of the proposed regime merely because they might, on an occasional basis, create small transitory short positions. Reporting should only be required where the information is clearly material and relevant.

The Consultation Paper proposes an initial reporting threshold of 0.25% of the issued share capital, which is the level currently used by the UK FSA and initially adopted by the US SEC. The Consultation Paper also sets out the SFC's reasons for suggesting 0.25% as a threshold, noting that the short selling / turnover ratio and short exposure / market capitalisation ratio are lower in Hong Kong than in London or New York. Based on the stock loan estimates for a sample of 320 Hong Kong stocks, the SFC concludes that 0.5% would be too high a threshold to capture short positions in around half the stocks sampled.

However, as stated earlier in the Consultation Paper, stock loan estimates are not a perfect proxy for short positions since stock loans can be for purposes other than short selling. Moreover the information received is estimated and likely to be incomplete as it is provided by some stock lenders on a voluntary basis[4].

A threshold of 0.5% for private reporting will provide more useful information to the SFC. We believe that it would be more efficient and meaningful only to require reporting to the SFC where a net short position exceeds 0.5% of an issuer's securities issued and outstanding. As mentioned above, it is difficult to obtain sufficient data from stock loan estimates to assess the most appropriate threshold for reporting. However, once the SFC starts to obtain information on short positions from reports, it will be able to conduct further analysis on this information and determine whether the threshold should be revisited. A threshold of 0.5% will minimize the initial impact on market participants, while allowing the SFC to more accurately assess risks rather than being inundated with data.

10. If you agree that short position reporting can be more relaxed during normal market situations and more frequent reporting with tighter threshold(s) may be required in the event of a contingency, what are the circumstances that may amount to a contingency situation (as this may need to be included in the

[4] Consultation Paper paragraph 9(b)

legislation)? Please provide reasons.

In general, we do not consider that there are circumstances which would merit application of more stringent standards and in the absence of evidence, there should be a uniform threshold for reporting. However, if the SFC identifies extreme market conditions in relation to particular stocks it may be useful to be able to have the power temporarily to reduce the threshold for private reporting, to enable the SFC to gather more information on short selling activity in that particular stock.

To avoid uncertainty, there should be clearly defined limits on any such power. The SFC should issue clear guidelines clarifying the circumstances in which enhanced reporting may be required, and the basis on which such enhanced reporting should be made. Any change in threshold made under a flexible threshold approach should be temporary, to allow the SFC to gather additional information over a period of particular concern, and the SFC should give sufficient notice before any change in threshold comes into force. Any permanent changes should only be made following a suitable period of consultation.

Examples of contingency situations which have been discussed by other regulators are price volatility in stocks in certain sectors and the situation where a company is undergoing a capital raising exercise.

No evidence that short selling leads to extreme market conditions. During the market turmoil, the price of shares in many financial companies experienced significant declines in a relatively short time period. We are not aware, however, of any evidence of a relationship between short selling and extreme market conditions. Recent academic literature has concluded instead that short sales do not affect the frequency of extreme negative returns. Similarly, studies of the effects of the recent short selling bans confirm that long sales, rather than short sales, were the primary cause of price declines in certain financial stocks.[5] In researching the effect of short selling on capital markets for its Discussion Paper[6], the UK FSA likewise found no correlation between negative stock returns and increased levels of stock lending in its analysis of the effects of its short selling ban.

No evidence that legitimate short selling is problematic during a capital raising. There is currently no evidence that indicates that short positions reaching a 0.25% threshold are more likely to be problematic during a capital raising than in other times. In addition, setting a different threshold in relation to capital raisings requires investors that engage in short selling to create additional systems to identify capital raisings as they are announced and to determine whether and when they trigger the disclosure/reporting requirement at the lower threshold.

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[5] Credit Suisse, Examining the Wake of the Short Selling Restriction, Market Commentary, Oct. 13, 2008.

[6] DP09/1

11. Are there any reasons why systems for complying with reporting requirements cannot be adjusted in the manner described in paragraph 26(d) above? What are other operational issues that we should consider? Please provide reasons.

Paragraph 26(d) of the Consultation Paper states that during a crisis the SFC may not be able to provide a sufficient period of notice for market participants to adjust their reporting systems to any change in threshold. The Consultation Paper states that market participants' systems should be sufficiently flexible to adjust to changes in threshold within a short time-frame.

As stated above, we do not consider that there are contingency situations which might require a flexible approach and in the absence of evidence the cost to market participants of building systems capable of adapting to a flexible approach and the potential for uncertainty should be weighed against the possible benefits to the SFC of being able to use the flexible approach.

While it should be possible to build a system which would support a flexible approach on thresholds, such a system is likely to be more difficult, and so more costly, to build. Market participants responded to the recent introduction of temporary short selling restrictions and disclosure requirements across Europe by implementing manual systems to monitor the new thresholds and restrictions rather than adapt their systems where there was uncertainty over the period of time that the new thresholds would be applicable. The regulatory uncertainty created by the imposition of these temporary short selling restrictions and disclosure requirements had a marked impact on trading, leading some participants to reduce their level of trading in certain markets, which in turn led to reduced liquidity.

In considering whether to adopt a flexible approach, the SFC should consider the situations where it may wish to tighten thresholds or require more frequent reporting, the frequency with which it is likely to exercise this power, and the length of time for which it might wish the tighter thresholds or more regular reporting periods to apply. If the SFC is likely to impose tighter thresholds or more regular reporting periods for a period of months, it should be possible to allow market participants a reasonable grace period to adapt. If the intention is to apply the flexible approach on short notice for a short period of time, the SFC should consider whether this approach would create uncertainty which would harm market confidence.

12. What are your views on the timing of reporting for the different approaches? Please provide reasons.

As discussed in our response to question 8 above, we consider that periodic reporting (with a threshold) to the SFC on a private basis would be the most appropriate approach. We would suggest reporting on a monthly or bi-monthly basis. However, in deciding the timing of reporting the SFC should take into account the complexity of the calculation required to

assess short positions and also the standard settlement cycle where settlement would occur on the third day after the trade date. In addition, these filing requirements are burdensome for individual investors, especially smaller investors with less sophisticated information technology systems. The calculations can be extremely challenging for firms, and in some instances may pose burdens that cannot be met with existing personnel and resources.

A longer timeframe for reporting short positions would be more practical. The Consultation Paper proposes reporting to the SFC on the business day following the day on which the short position was exceeded (T+1), by reference to end of day data. Taking into account the factors set out above, we would recommend that monthly reports are submitted to the SFC on the third business day following the end of that calendar month.

Extended transitional period necessary. Given the degree of investment likely to be required, it will be necessary for there to be an extended transitional period before any new requirement comes into force.

13. **Should the obligation to report short positions be placed on holders of short positions? Please provide reasons.**

14. **Should agents be permitted to report information on behalf of holders of short positions with the holders of the positions being held accountable? Please provide reasons.**

15. **In the case of funds, should the reporting requirements apply to individual funds rather than to the fund manager? Please provide reasons.**

16. **Do you agree that aggregation requirements should not be imposed on different entities within the same group? Please provide reasons.**

The SFC should analyse the data currently provided to it under Section 171 of the Securities and Futures Ordinance, and determine whether an additional requirement for individual investors to report short positions would in fact increase transparency of short positions, over and above the transparency provided by the current regime.

The default position should require reporting at the level of the legal entity or asset management company, but there should be flexibility where this information could be misleading. As regards the level of reporting to the SFC, if the SFC determines that a reporting obligation is necessary and beneficial, we consider that the focus should be on where the investment decision is taken and that, therefore, the starting point is that disclosure should be at the level of the decision making entity. This will be the legal entity or, in relation to asset managers, the asset management company (rather than the individual fund).

However, there is a real danger that one size will not fit all, in particular because asset management companies will frequently act for clients representing a wide variety of

investment strategies. Reporting net positions across several different strategies could be unhelpful. Therefore there ought to be the flexibility for investors to select larger or smaller reporting units where this would provide more meaningful information. The SFC should establish criteria to determine situations where different reporting units may be appropriate (for example, where a unit of an investment manager acts independently of other units, so that aggregating its interests with those of other units would be misleading).

17. What are your views on providing in the report to the SFC the net short position and the net position established on the SEHK? Please provide reasons.

18. What are your views on the creation of a template to facilitate electronic reporting through the SFC's website? Please provide reasons.

We consider that the creation of a template to facilitate electronic reporting through the SFC's website would be helpful to investors in making their reports.

Privately reported data should be kept confidential. The information reported to the SFC should also be subject to an obligation on the SFC to keep such information confidential.

We agree that the reports should contain information on the identity of the reporting party, the issuer, the size of the position and the date on which the relevant position was created or no longer held. However we do not consider that investors should be required to provide greater breakdowns of positions. In particular we do not consider that investors should be required to calculate their net position established on the SEHK (whether long or short). This adds a further level of complexity to the calculations required, and is likely to have consequential cost or timing implications for reporting.

19. Should the information reported to the SFC be disclosed publicly on an aggregated and delayed basis? Please provide reasons.

We support the goal of increasing the level of information on short selling available to the SFC through private reporting. However, we do not consider that any reporting regime should require public disclosure of individual short positions. Public disclosure of short position information that identifies individual investors and their short positions may be misinterpreted by other market participants, increase market volatility and harm the trading strategies developed by investment managers and analysts to serve their investors.

The SFC already publishes short selling information based on the information gathered through the Section 171 Securities and Futures Ordinance requirement. The SFC should consider whether additional information would be of further benefit to the market. However, if the SFC considers that public reporting is necessary and beneficial, it should make

available to the public aggregated anonymised data on short selling using the information privately reported to it.

Private reporting will provide useful information without the harmful effects of public disclosure. As discussed below, private reporting of short selling information would provide relevant, useful information to the SFC while mitigating the harmful consequences of public disclosure. Private reporting would meet the objectives described in the Consultation Paper for the SFC to receive information to allow it to identify significant short positions and to conduct further investigation into whether short selling may lead to disorderly markets.

Only private reporting should be required. For the reasons set out above, we do not agree that the regime should require public disclosure of individual short positions. We consider that the regime should only require investors to report short positions to the SFC (on a confidential basis). As the Consultation Paper states, private reporting would provide the SFC with "early warning signs of a build up of large short positions" that may be potentially disruptive to the orderly functioning or stability of the market, and would help the SFC identify whether short selling activity potentially leads to price amplification effects and disorderly markets.[7] Private reporting would protect investors' trading and risk management strategies and avoid a chilling effect on the benefits short selling provides to the market, including enhancing liquidity, increasing market efficiency and facilitating price formation.

Require publication of aggregate anonymised data if supported by evidence. If there is evidence available to the SFC showing that public reporting is necessary and beneficial, any proposed rules should only require the SFC to make available to the public aggregated anonymised data on short selling using the information privately reported to them. We think that there should be extensive analysis and market testing to determine which aggregate and anonymised data are actually useful to investors, combined with careful analysis with respect to the content and timing of any disclosures to ensure that the data provided is not liable to be misinterpreted and does not itself create the possibility of short squeezes[8].

If the cost of producing such data is too high, the SFC may publicly disclose anonymised data at a higher threshold (such as 2%). If the cost of producing aggregate anonymised data for public disclosure is too high, the SFC should consider publicly disclosing anonymised versions of individual private reports of short positions, but at a higher threshold (such as 2%). This system is likely to be less costly for the SFC to operate and may mitigate some of the risks arising from disclosures that identify individual investors, such as the risk of adverse issuer reaction to a particular investor. However, even such anonymised information is still

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[7] Consultation Paper paragraph 6

[8] A short squeeze occurs where the price of a security rises as a result of increased demand and limited supply, causing investors to purchase shares to close out their short positions, creating a further increase in demand for securities which are already in limited supply, triggering a further rise in price.

(even if only disclosed at a higher threshold) likely to be misinterpreted by investors, to cause some market participants to refrain from performing critical risk management functions and to result in increased volatility and the risk of short squeezes.

Public disclosure of short positions likely to be misinterpreted by investors. We believe public disclosure disadvantages those issuers whose stock is shorted and the investors who are long in that stock. Public disclosure of short positions is likely to be misinterpreted, as investors frequently short a stock for portfolio risk management purposes rather than because they have taken a negative view on a particular issuer. For example, an investor that is primarily long in stocks in a particular industry sector may consider that one issuer's stock is likely to outperform another and may express that view by going long the first and short the second stock. Under the SFC's proposals, investors engaging in these strategies would not be able to net their long positions in one issuer's stock against their short sales in another stock for disclosure purposes. Therefore, the investing public could mistakenly interpret disclosure of the information on the short sale as an absolute negative view on that issuer's prospects. Misinterpretation of this information is likely to have a greater impact on those industry sectors which are vulnerable to negative public sentiment, in particular financial institutions.

Public disclosure leads to "herding" and increased volatility. Public disclosure of market participants' short positions may lead to an increase in shorting of stocks as other market participants seek to execute trades which follow firms' publicized short positions. This would increase market volatility. There are examples of situations in recent years where the behaviour of a high profile investor is likely to have influenced the activity of other market participants. This is a particular concern for MFA members, many of whom have well established market reputations.

Public disclosure has market effects that result in increased costs for all investors. All equity market participants would realize increased costs associated with trading equities under regulatory regimes that require public disclosure of short positions. Institutional and retail investors alike would also experience increased transaction costs (i.e. wider bid-ask spreads) and longer times to fill orders. Short selling is critical for price discovery, and market participants gain confidence when both positive and negative views are expressed in the market. In addition, short selling can impose a useful discipline on many issuers who do not provide the requisite transparency to investors regarding their financial condition.

Public disclosure may cause issuers to react adversely to short sellers. Public disclosure of short positions would also have harmful consequences to investors. A number of issuers have indicated that if they can identify which firms have been shorting their securities, they will cease or limit communications with analysts of those firms and exclude them from information sessions. Such a result would have a negative impact on capital markets by limiting the free flow of information essential for informed investments and effective price discovery. We are concerned that the public disclosure of detailed short positions would have long lasting negative effects on the market by having a chilling effect on the information

and disclosure provided by issuers, as well as harming the relationship between investors and issuers. This is a particular concern for MFA members, who believe that it is necessary to have equal access to information from issuers to better serve their own investors by pursuing properly informed investment strategies.

Adverse publicity arising from public disclosure may avert investors from benefiting from alternative investment classes. In addition, a number of pension, endowment and foundation investors in the U.S. have indicated to our members that because of risks of adverse publicity resulting from public misunderstanding of the function of short selling, they would likely withdraw their investments from investment vehicles engaged in short selling if they were required to publicly disclose short positions. In the long-term, such investors would forego diversification and risk management benefits provided by alternative investment vehicles.

Adverse publicity associated with public disclosure may discourage use of hedging strategies. Public disclosure of short position information could have unintended consequences to hedging strategies of investors. Hedging strategies are a critical risk management tool of investors and enable them 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. Because of concerns about adverse publicity, public disclosure of short positions may discourage investors from engaging in short sale transactions for hedging purposes, reducing investors' ability to manage risk, and decreasing market liquidity and capital formation. While these concerns would be reduced if an investor's net short position for a particular security remains below the disclosure threshold, investors, such as MFA members, frequently hedge risk through short sales of different issuers with highly correlated share prices (e.g., companies in the same industry sector).

With the reduced usage of hedging strategies there may also be unanticipated secondary effects. Certain investment strategies use short equity positions to hedge exposures in other products. Convertible arbitrage, for example, relies on short equity positions to hedge exposure in convertible bonds. Were alternative investment managers and other investors to lose the ability to hedge these risks there is a possibility that their appetite for products such as convertible bonds could diminish. As convertible bonds represent a cheaper source of funding than traditional bond issuance short selling disclosure could have real impacts on the financing ability of companies whose equity is subject to regulation. There are many MFA members that pursue these strategies and are significant investors in primary offerings of convertible securities.

Public disclosure exposes investors to risks of short squeezes. In addition, public disclosure of short positions may expose market participants to the risk of a short squeeze, which again may deter investors from engaging in short selling.

Public disclosure reduces incentives to develop trading strategies that use short selling. Public disclosure of information could permit other market participants to unfairly reverse engineer the trading strategies of an investor. Public disclosure would likely cause harm to the trading strategies of investment managers, and by direct implication the billions of dollars invested in those strategies by investors through vehicles 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.

Holders of short positions are exposed to unlimited loss in the event of stock prices increasing before they can unwind their position and are also exposed to potential squeezes as a result of public disclosure as it is clear that they will be required to unwind their position at some point.

Experience since the crisis provides insufficient evidence to support public disclosure. The rules imposed by some regulators requiring public short position disclosure have only applied to a narrow range of financial stocks, for a relatively short period and in exceptional market conditions. It is difficult to extrapolate from this experience reliably to confirm the absence of likely adverse effects from extending the regime more broadly.

However, as stated above, the US regulatory regime did not provide for public disclosure of short interest in financial stocks, while the UK regime did include such a provision. Liquidity in the affected stocks was better over this period in the US, and bid-ask spreads were significantly tighter. We know that some MFA members have reduced their participation in the markets as a result of the introduction of public disclosure regimes for short selling.

Public disclosure is likely to reduce the efficiency of price discovery. We strongly believe that public disclosure would reduce pricing efficiency.

First, as noted above, we believe that in many cases, information on short positions is likely to be misinterpreted if publicly disclosed and may lead to "copycat" investor behaviour which itself exacerbates pricing volatility.

Secondly, public disclosure of short positions will cause potential short sellers to either refrain from engaging in short sales entirely, or to reduce their short sale transactions to avoid triggering the public disclosure requirements. This reduction in short selling activity will adversely affect pricing efficiency. Academic studies on the effects of short selling, most notably those examining the effects of recent short selling prohibitions, strongly support the view that short selling contributes to pricing efficiency.[9] If a public disclosure requirement

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[9] 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,

causes investors to artificially reduce their level of short selling to remain below the disclosure threshold, as anticipated, the disclosure requirement would lead to diminished pricing efficiency in the markets.

Public disclosure will not enhance market stability. As noted above, we remain deeply concerned about the ongoing crisis within global financial markets. A public disclosure requirement, however, would discourage investors from taking short positions exceeding the disclosure threshold during times of market stability. If the public disclosure requirement effectively acted as a restraint on short selling, it would have pernicious effects for market efficiency, liquidity and price discovery similar to those of a short selling prohibition, and would discourage investors from fully implementing risk management strategies or taking directional short positions based on proprietary research. When investors with capital at risk engage in short selling, markets are more efficient, investors are able to better manage their risk, and securities' prices are more accurate. For these reasons, we believe a public disclosure requirement would provide only limited benefits, if any, and would not enhance market stability.

20. If the information is published on a delayed basis, what would be the appropriate 'delay' (e.g., on a weekly basis for positions as at the end of the preceding week)?

If the SFC does decide to publish information on an aggregated delayed basis it should be aware that the information will require interpreting by other market participants and will still be open to misinterpretation. The SFC should consider what information might be useful to market participants, and whether public disclosure of aggregate information on a delayed basis is beneficial and appropriate.

21. Should the SFC consider any exemptions from the reporting requirements? Please provide reasons.

We consider that, if there are to be any exemptions for market making or liquidity providing activity, in framing the scope of the exemptions the SFC should take into account the effect of advances in technology and changing market structures which have led to a growing range of types of entity and roles within the market which act to improve liquidity and aid price discovery and the potential competitive advantage given to those who benefit from the exemption over other market participants.

N., Efficiency and the Bear: Short Sales and Markets Around the World, 2007, Journal of Finance, Vol. 59, No. 4.

22. Do you agree that the short position reporting requirements should not be homed in Part XV of the SFO or mirror the Part XV requirements? Please provide reasons.

To the extent possible, we would support harmonisation of any new rules with existing rules to avoid placing onerous costs and compliance obligations on market participants. However, we appreciate that Part XV contains some complicated features which may not be appropriate to be reflected in a short position reporting requirement and agree that it would be more appropriate to adopt new subsidiary legislation which can be tailored to the needs of the short position reporting regime.

CONCLUSION

Along with policy makers, MFA and its members remain deeply concerned about the ongoing crisis within global financial markets and support timely and targeted initiatives aimed at preventing the crisis from worsening by restoring market integrity and confidence and encouraging investors to return to a more normal market environment. A primary cause of this crisis has been the inadequate risk management practices of global financial institutions. Investors, including alternative investment funds, should not be penalised for accurately predicting that the share prices of poorly managed firms were likely to decline and for making investment decisions based on those predictions, including the reduction of long exposure or short selling for hedging purposes. It is widely acknowledged that short selling plays an integral role in the proper functioning of markets, as it contributes to efficient price discovery, increases market liquidity, and promotes capital formation, among other benefits.

MFA welcomes the opportunity to participate in this important debate and looks forward to an ongoing dialogue with the SFC. MFA would also be pleased to respond to any additional inquiries as the SFC considers the appropriate short selling regime.

If you have any questions or comments on this submission, in the first instance please contact Stuart J. Kaswell, Executive Vice President and General Counsel, at +1 (202) 367-1140 (stuart@managedfunds.org).

Yours truly,

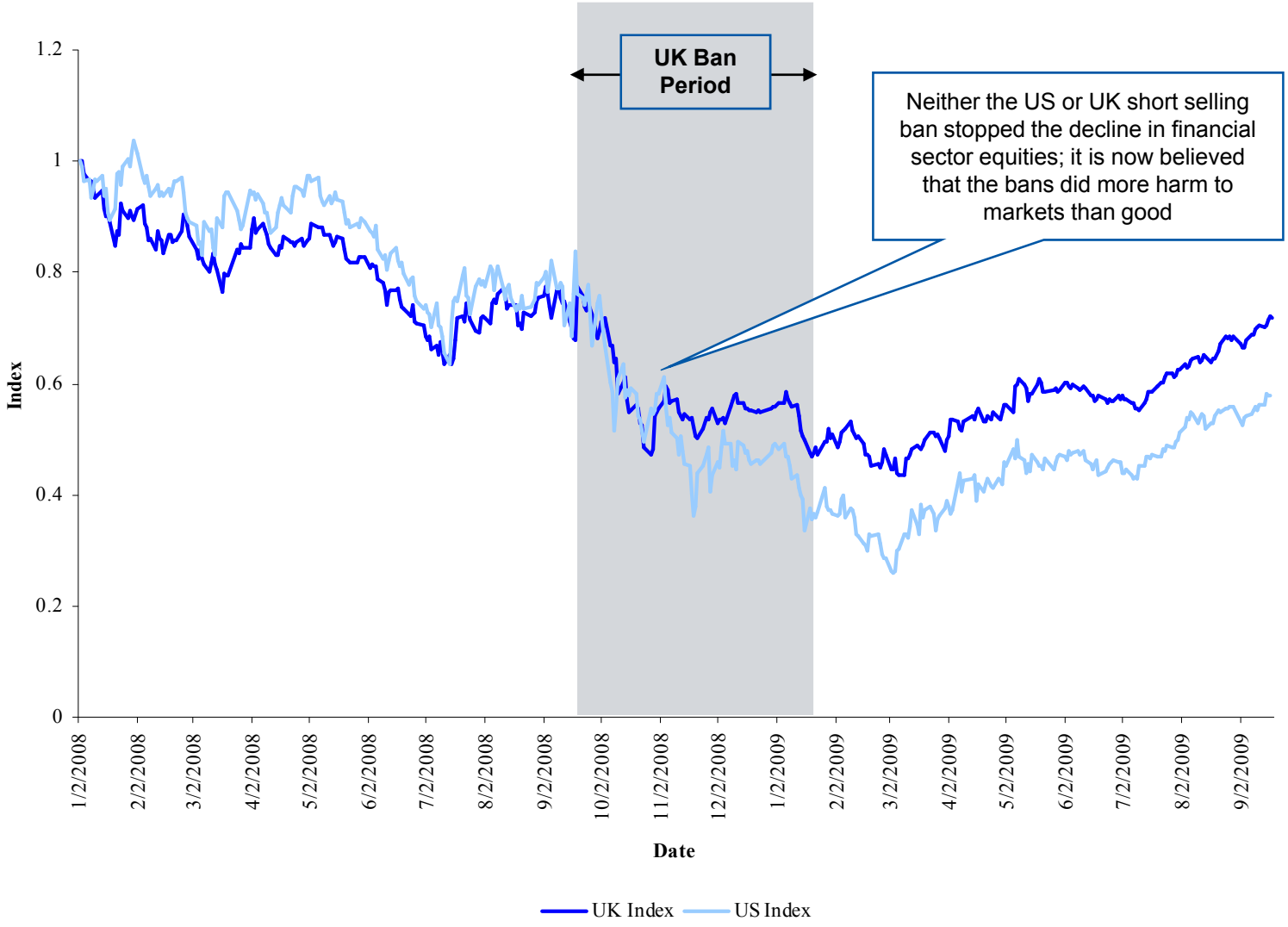
/s/ Richard H. Baker

Richard H. Baker
President and Chief Executive Officer

/s/ John G. Gaine

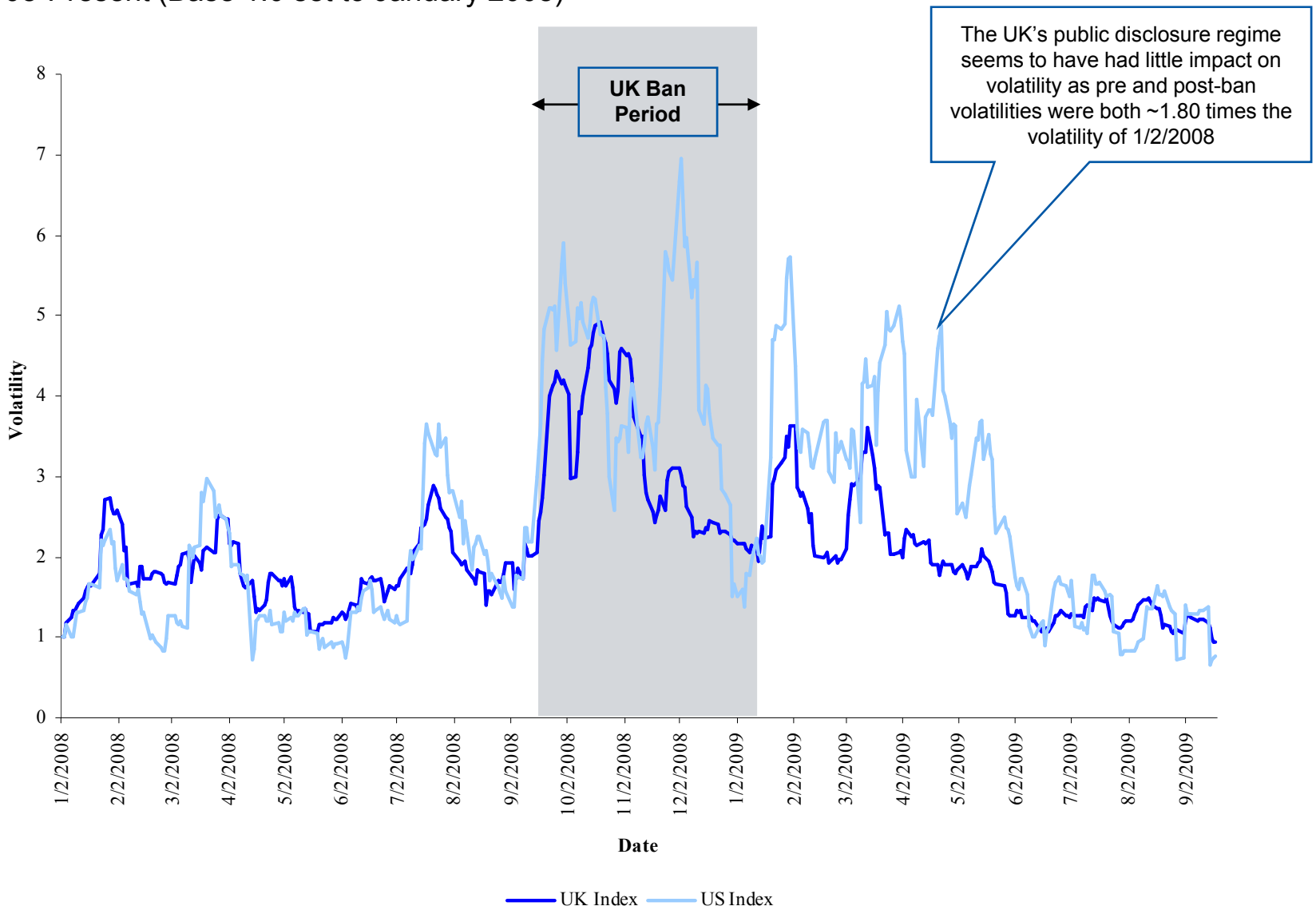
John G. Gaine
President Emeritus and Special Counsel, International Affairs

US Financials Index vs. UK Financials Index
2008-Present (Base 1.0 set to January 2008)



Source: Bloomberg

US Financials Index vs. UK Financials Index
2008-Present (Base 1.0 set to January 2008)



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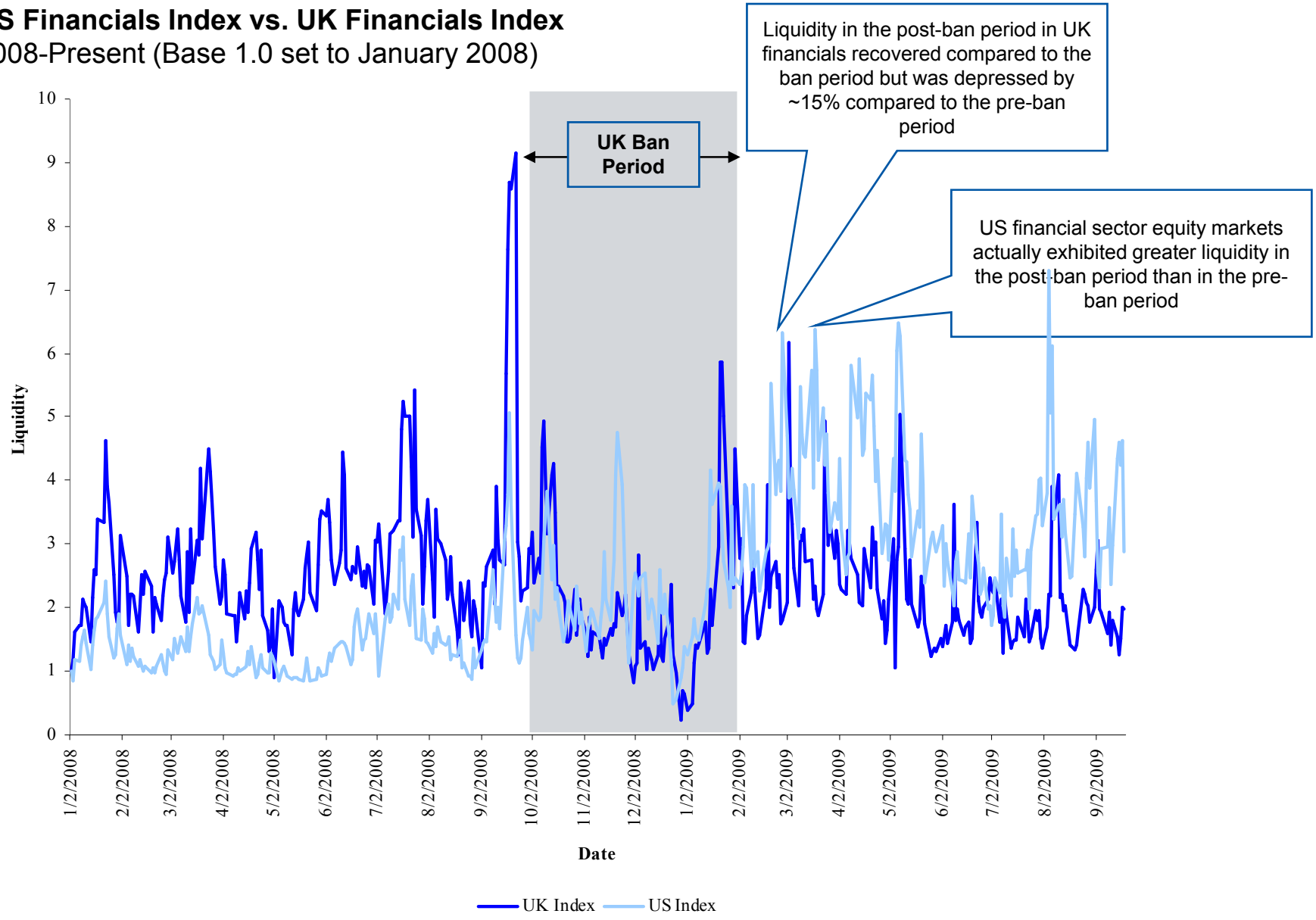

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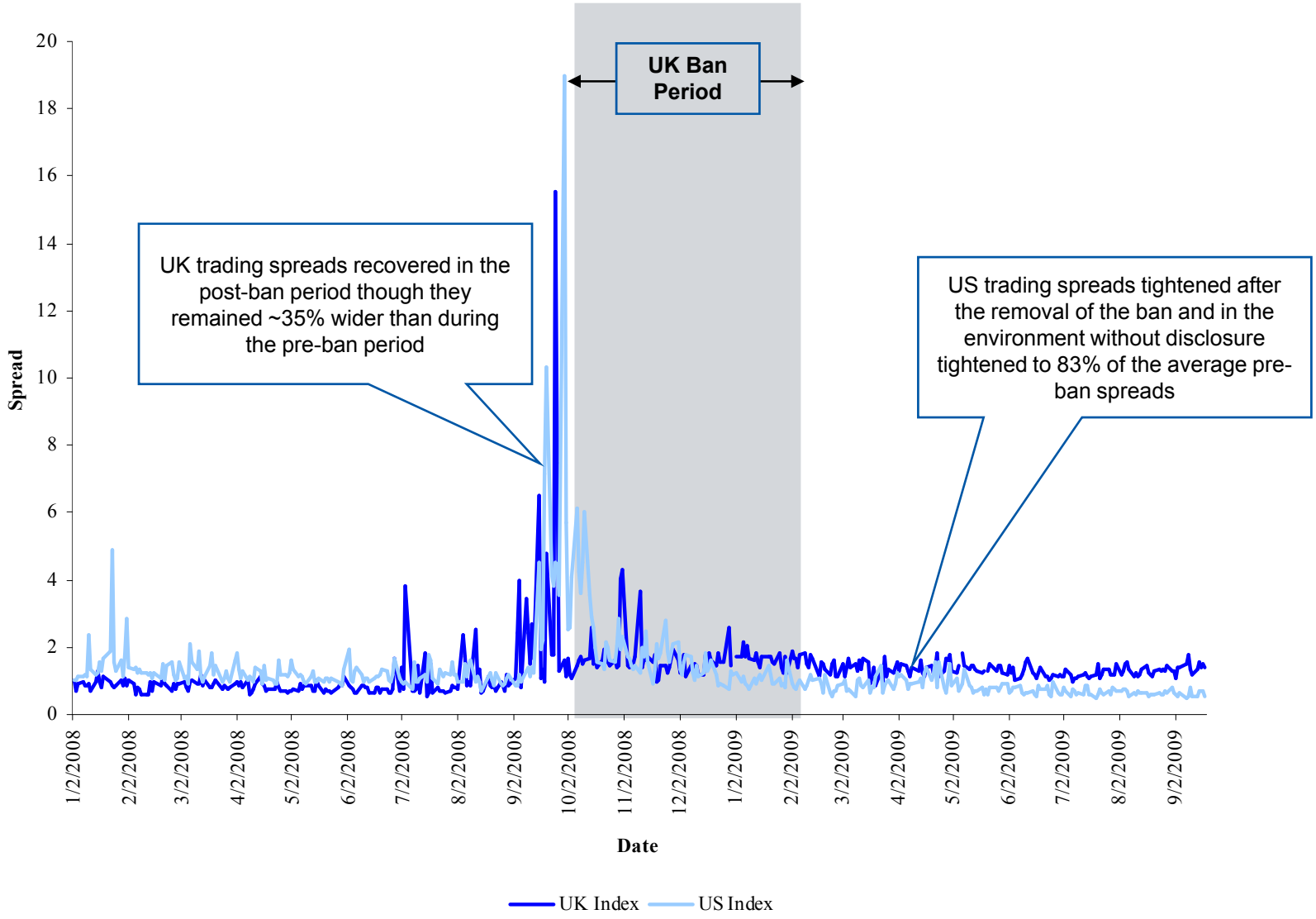

Source: Bloomberg