MANAGED FUNDS ASSOCIATION

September 19, 2006

VIA ELECTRONIC MAIL: rule-comments@sec.gov

Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Attention: Nancy M. Morris, Secretary

Re: Proposed Amendments to Regulation SHO; File No. S7-12-06

Ladies and Gentlemen:

In response to the request of the Securities and Exchange Commission (the "Commission"), Managed Funds Association ("MFA") offers the following comments on Securities Exchange Act Release No. 54154 (July 14, 2006) (the "Release"), "Amendments to Regulation SHO" ("Regulation SHO").[1] We appreciate the opportunity for all segments of the trading and investing community to offer their views on proposed Commission actions, and we hope that our comments prove helpful to the Commission. As discussed below, we support the Commission's proposal to eliminate the Regulation SHO grandfather provision and urge the Commission to carefully consider the impact on option liquidity that might result from narrowing the options market maker exception.

Managed Funds Association ("MFA") is the only U.S.-based global membership organization dedicated to serving the needs of those professionals throughout the world who specialize in the alternative investment industry, including hedge funds, commodity pool operators, funds of funds and managed futures funds. MFA's over 1,100 members include professionals from the majority of the 50 largest hedge funds, which manage a significant portion of the estimated $1.3 trillion in assets under management currently invested with hedge funds.

Introduction

MFA regards short selling as an essential method by which investors, including fiduciaries managing others' assets, can manage risk, hedge their portfolios, and reflect their view that the current market price of a security is higher than it should be. The benefits of short selling to the broader

[1] 71 FR 41710.

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market are well known.[2] Short selling provides liquidity to the market and makes markets more efficient.

MFA supports the Commission's efforts to modernize short sale regulation in Regulation SHO. We recognize that in Regulation SHO, the Commission sought to limit abuses while allowing legitimate and important market practices. MFA recognizes that short selling—like purchases of stock—can be abused and can adversely affect the markets, but we believe that many of the negative or hostile views of short selling are based on misunderstandings about the nature and mechanics of short selling.

As the Release makes clear, the focus of Regulation SHO is not short sales *per se*, but failures to deliver securities on the scheduled settlement date (commonly known as fails). The Release also notes the often-overlooked fact that fails can result from short sales <u>and</u> long sales, and can result from a variety of causes. Regulation SHO seeks to reduce the number of fails in two principal ways: a broker-dealer executing a short sale must locate a potential source of stock reasonably believed to be available to deliver at settlement; and a broker-dealer that has an extended fail to deliver position in a "threshold security" must take steps to "close-out" that position by purchasing the stock. The regulation is having its intended effect of reducing fails to deliver.[3]

We commend the Commission for its efforts to reduce failures to deliver, but believe that it is important to keep failures to deliver in perspective as the Commission considers the need for additional regulation in this area. As the Release shows, the overwhelming majority of trades settle on time and only a minute fraction of trades experience settlement failures.[4] We believe that the real issue presented in the proposed amendments and the discussion in the Release is not failures to deliver as such, but "naked short selling,"[5] or more accurately, *abusive* naked short selling. As the SEC Staff has noted, "Naked short selling is not necessarily a violation of the Federal securities laws or the Commission's rules. Indeed, in certain circumstances, naked short selling contributes to market

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2 *See*, e.g., Arturo Bris, William N. Goetzmann and Ning Zhu, "Efficiency and the Bear: Short Sales and Markets Around the World" (Yale School of Management, Jan. 2003), a study of forty-seven stock markets around the world, in which the authors found that markets with active short sellers reacted to information more quickly and set prices more accurately; and Owen A. Lamont, "Go Down Fighting: Short Sellers vs. Firms", available at http://www.som.yale.edu/faculty/oa14/research/go%20down%20fighting.pdf (concluding that constraints on short selling as a result of various actions taken by firms allow stocks to be overpriced and that firms taking anti-shorting actions have in subsequent year abnormally low returns of about minus two percent per month).

3 *See* 71 FR at 41711 & n.18.

4 Ninety-nine percent (by dollar value) of all trades settle on time, and the vast majority of fails are closed out within five days after the normal settlement date. Id. at 41710 n.3. Moreover, only 0.38% of all equity securities are threshold securities. Id. at 41712 n.19.

5 *See, e.g*, 71 FR at 41710. The Release describes naked short selling as "selling short without having stock available for delivery and intentionally failing to deliver stock within the standard three-day settlement period."

liquidity."[6] MFA believes that the real concern lies with abusive naked short selling and would support the Commission dedicating more of its regulatory and enforcement resources to preventing abusive trading in general, rather than singling out short selling.

In addition, and as noted by leading scholars from academia and industry at the SEC's Roundtable on the Regulation SHO Pilot,[7] there is no persuasive evidence that short selling is more frequently abusive than other types of transactions. Indeed, manipulative purchases—for example, so-called pump-and-dump schemes—appear to be far more common than abusive short sales. There are far more market manipulation enforcement cases against boiler room operations than short sellers.

General comments

We provide specific comments on the proposed amendments below, but we wish to emphasize a few important general points concerning the Commission's release.

First, we support the Commission's proposal to remove the Regulation SHO grandfather provision if the Commission is confident that doing so will materially reduce the extent of fails in threshold securities. We support the proposed amendments not because we believe the (low) number of fails evidence misconduct or abuse, but because we believe it is important for the Commission to address the negative public perception regarding extended fails.

Second, we commend the Commission for seeking input from all market participants about many aspects of the operation of Regulation SHO. Because new requirements, even those carefully considered before implementation may have far reaching, unintended adverse consequences or be subject to abuse, we urge the Commission to proceed incrementally in adopting additional short sale regulation in order to minimize the adverse effects of significant unintended consequences.

Third, MFA strongly believes that regulation of short sales (including fails to deliver) is an area that must be governed by uniform, national rules. Varying perceptions (many of which we believe are misperceptions) of short selling or parochial interests could drive local jurisdictions to adopt requirements for short sales or fails to deliver that could vary with, for example, the location of the seller or the company whose stock is being sold. A patchwork of different short sale regulations would have a significant adverse impact on the markets. Therefore, we urge the Commission to assert its comprehensive authority to regulate short sales.[8]

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6 Division of Market Regulation: Key Points About Regulation SHO, Section II (SHO Key Points).

7 SEC Roundtable on the Regulation SHO Pilot (Sept. 15, 2006) *webcast at* http://www.connectlive.com/events/secshoroundtable/.

8 *See, e.g.,* Section 10(a) of the Securities Exchange Act of 1934, 15 USC 78j(a).

Comments on proposed amendments

Amendments to the grandfather provision in Rule 203(b)(3)(i). MFA supports the Commission's proposal to eliminate the grandfather provision based on the Commission's view that doing so will substantially decrease the extent of fails in threshold securities.

We recognize that there is a great deal of public confusion and misunderstanding when it comes to failures to deliver, and believe it is important to address this. For this reason, we support the Commission's efforts to further reduce failures to deliver. We do not, however, believe that the limited number of failures to deliver evidence misconduct or abuse.

Amendments to the options market maker exception in Rule 203(b)(3)(ii). The options markets are very important to many market participants, including MFA members. MFA believes that options exchanges and market makers themselves are in the best position to assess the impact of this proposed amendment. Therefore, we urge the Commission to carefully consider the views of any options market maker and options exchange that comment on this proposal. The Commission should not approve any changes that would materially decrease liquidity in the options markets.

Comments on other questions

Disclosure of fail positions. The Release asks whether the Commission should require the amount or level of fails to deliver in threshold securities to be publicly disclosed, and whether such disclosure should be on an aggregate or individual stock basis. MFA is not aware of sound arguments or evidence showing that more transparency of fail positions would decrease the level of persistent fails. We are strongly opposed to the publication of fail positions of individual market participants. We are highly concerned that such information would reveal proprietary information, including trading strategies and expose customers to potential short squeezes.[9] Additionally, we understand that such a requirement would require broker-dealers to expend considerable resources to unravel complex processing streams. Without further evidence of the benefits that would be derived from disclosure of fail positions, we do not believe that the benefits of this requirement will justify the costs or risk of exposing proprietary information.

Account level tracking of customer fails. The Release asks whether the Commission should amend Regulation SHO to require firms to track and close-out fails to deliver at the individual account level. MFA supports the current framework and opposes requiring individual account level tracking. As we understand it, a mandatory buy-in at the account level as opposed to the firm level is not feasible with current settlement practices and procedures. Requiring individual account level tracking to identify fails to deliver would entail massive systems and process changes—basically unwinding the move to the indirect securities holding system that has served the market so well—which would be

9 We believe the Commission correctly refrained, despite being urged in the past to adopt rules to require public reporting of individual short positions, from requiring such disclosure. *See* Securities Exchange Act Release No. 29278 (June 7, 1991), 56 FR 27280.

costly and disruptive. We are also concerned that the methodologies to determine which customer's transaction or account gave rise to a failure to deliver could lead to inequitable and unpredictable results.

Rule 144 sales. The Release asks: "Should the current close-out requirement of 13 consecutive settlement days for Rule 144 restricted threshold securities be extended, *e.g.*, to 35 settlement days?" While Rule 203(b)(2)(ii) seems to suggest that delivery of securities on sales covered by that rule is not required for 35 (calendar) days, the SEC Staff has stated that the closeout provisions of Rule 203(c)(3) operate independently from the 35 day provision.[10] Therefore, if a firm has a fail to deliver position in a threshold security that persists for 13 settlement days, that position must be closed out irrespective of whether a portion of the position is represented by a fail related to the sale of Rule 144 shares. The question in the Release is essentially asking whether fails on Rule 144 sales should be treated independently of other fails. MFA believes that the answer is "yes," as further discussed below.

Registered Resales. Just as the Commission has indicated that fails to deliver can be prejudicial to the market for a particular security, we believe that there is a similar and even more prevalent concern with respect to registered sales of securities bearing restrictive legends. All too often, investors experience problems with the delivery of securities which are no longer legally restricted, yet still bear a restrictive legend. In the experience of our members, it is not unusual to take more than 13 days and occasionally more than 35 days for a restrictive legend to be removed from a security in a rule 144 sale or a registered resale. The delivery delay caused by the extensive time it takes to remove a restrictive legend is burdensome and prejudicial to investors and creates a greater level of uncertainty in the markets. We respectfully request that the Commission work with transfer agents and issuers to improve the process for removing restrictive legends of securities for resale delivery and to strengthen investors' confidence in the markets. Additionally, this would have the secondary benefit of reducing failures to deliver by addressing the root cause of certain fails.

We also support extending the close-out requirement for Rule 144 restricted threshold securities to 35 days, and believe that the additional time to deliver securities should be available in all cases covered by Rule 203(b)(2)(ii), *i.e.*, where a person sells a security that he or she is deemed to own, but cannot deliver it in the normal settlement cycle due to factors beyond the seller's control, and the broker-dealer has been reasonably informed that the person intends to deliver the security as soon as the security becomes available. This situation can occur, for example, where delivery requires the conversion of a convertible security or the exercise of a warrant, and where transfer restrictions must be removed from the underlying privately placed shares, among other situations. We support

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10 Division of Market Regulation, "Responses to Frequently Asked Questions Concerning Regulation SHO," Question 5.6 (SHO FAQ). Rule 203(b)(ii) is technically an exception from the locate provision of Rule 203(b)(i), but has imbedded in it a buy-in requirement that is similar to the close-out requirement of Rule 203(b)(3)(iii).

extending the close-out requirement for Rule 144 restricted threshold securities and all cases covered by Rule 203(b)(2)(ii) to 35 days.[11]

Affirmative determination for long sales. The Release asks whether broker-dealers should be required to document information with respect to securities that will be sold long for a customer, and notes that former NASD Rule 3370 had such a requirement. That rule has been rescinded for some time now. This requirement should be considered only if there is substantial empirical evidence showing that long sales are contributing to a troublesome level of fails, and that the lack of documentation about an affirmative determination is related to those fails.

Pre-trade documentation requirements can unnecessarily impair efficiency. In the context of electronic trading, for example, additional requirements to obtain and record information from customers can require costly system changes and can cause investors to miss perceived trading opportunities. Requiring additional documentation relating to long sales should be considered only where the costs clearly outweigh the burdens.

Decrementing locates. The Release asks whether the Commission "should amend Rule 203(b)(1) to provide for stricter locates?" Implicit in this question is the notion that there is a problem with the locate process that is leading to an unacceptable level of fails. However, the SEC staff has acknowledged that failures to deliver can arise from a variety of causes, many of which are not problematic.[12] The Release asks whether broker-dealers should be required to obtain locates only from sources that agree to, and that the broker reasonably believes will, decrement its position in the shares. We understand decrementing to mean that, once a lender has indicated to a trader that it has securities that can be available for delivery in the three day settlement cycle, the lender must "freeze" those shares so that they are not available to support a locate for another trader in that time period.

However, a locate is not a commitment to lend nor a borrowing of securities, and so there should be no deduction from a lender's position simply for providing a locate. MFA believes that such "external" decrementing described above is not general industry practice, would require significant systems and procedural changes for many firms, and would substantially impair liquidity and the feasibility of short selling. We note that some lenders "internally" decrement based upon their market experience, so that they and their clients can be reasonably confident that the necessary amount of

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11 The current text of Rule 203(b)(2)(ii) makes the removal of "restrictions on delivery" the focus of the provision. The rule text is arguably narrower than the discussion in the Regulation SHO adopting release, which indicates that the 35 day period is available in many situations where delivery within the normal settlement timeframe is not possible. *See* Release 34-50103 (July 28, 2004), 69 FR 48008, 48015. Therefore, we suggest that the rule be changed to reflect the scope of the provision. For example, the phrase "all restrictions on delivery have been removed" could be replaced with "all impediments to delivery have been removed" or, preferably, "the securities are received by the seller."

12 *See* SHO Key Points, Section II.

shares will be available to deliver on their trades. We believe that this is a good practice that should be encouraged but not mandated.

Regulation SHO is based on a "reasonableness" standard. Until fails become problematic (*i.e.*, securities become threshold securities) or a broker has information that sources of locates are not reliable, the Regulation permits the broker-dealer to use its reasonable judgment about whether shares will be available to settle long sales and short sales on a timely basis.[13] MFA believes that reasonableness continues to be the appropriate standard to apply to the locate requirement, unless it can be clearly shown that the present locate process is related to a troublesome level of failures to deliver. We are also concerned that a decrementing requirement could be abused. A person interested in tying up shares could call multiple lenders for locates for shares that will not be needed by that trader, requiring the lenders to decrement their positions, and thereby reducing the amount of locates available to other traders.

We respectfully request clarification of the statement in the Release that: "Rule 203(b)(1)'s locate requirement generally prohibits brokers from using the same shares located from the same source for multiple short sales." In SHO FAQ 4.4, the SEC Staff stated that multiple short sales on the basis of the same locate <u>are</u> permitted in "buy-to-cover" situations, *i.e.*, where a trader obtains a locate and sells short but purchases an equivalent amount of securities on the same day. In that case, the trader can re-use the original locate provided that the subsequent short sale is for an amount of securities that is no greater than the amount of the locate, and the source of the located shares indicates that the original locate is good for the entire trading day. MFA believes that this is a sensible position and facilitates efficient trading. We therefore request that the Commission confirm that it is not overruling the Staff on this point, and that that is what the use of the word "generally" in this sentence was intended to reflect.

<u>Mandatory pre-borrow</u>. The Release asks whether the Commission should impose a mandatory pre-borrow requirement on *all* firms "whenever there are extended fails in a threshold security regardless of whether that particular firm has an extended fail…." The way in which this might work is not clear. There is no way for firms to know whether a particular firm has "an extended fail," which presumably refers to a closeout obligation, unless the Commission or an SRO makes that information available or the firm self-reports that fact. That disclosure, however, would reveal potentially sensitive market information, which MFA believes would be inappropriate and harmful to market participants. The only "feasible" information upon which this requirement could be based is the fact that a security has become a threshold security (even though no firm may be in a closeout situation). In any case, by requiring all firms to pre-borrow prior to effecting short sales, costs will escalate and liquidity will be adversely affected.

We have a concern that this requirement would be subject to abuse. A person with a large long position in a threshold security could intentionally trigger the pre-borrow requirement suggested in the

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13 *See, e.g.*, Rule 200(g)(1)(ii), 203(a)(2)(ii); 203(b)(1)(ii); 203(b)(2)(ii).

Release by failing to deliver on a large sale and cause its brokerage firm to fail to close-out an extended fail position. Any reduction in liquidity from the operation of the market-wide pre-borrow requirement could lead to pressure on short sellers (reducing their activity or creating short squeezes) resulting in a rise in the stock price. The person with the long position could also benefit from this situation as a stock lender.

For these reasons, MFA believes that mandatory market-wide pre-borrowing is not warranted and would be detrimental to the markets.

Conclusion

MFA appreciates the opportunity to provide its views on the proposals and questions that the Commission has promulgated. We would welcome an opportunity to meet with Commissioners and the Staff if that would provide assistance in your deliberations on these issues.

Respectfully submitted,

John G. Gaine

John G. Gaine
President

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