June 19, 2009

The Honorable Mary L. Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. S7-08-09; Rel. No. 34-59748
Amendments to Regulation SHO

Dear Chairman Schapiro:

The Coalition of Private Investment Companies ("CPIC")[1] is pleased to submit its comments regarding the above-referenced proposal of the Securities and Exchange Commission ("SEC" or "Commission") to limit short selling, through several proposed alternative amendments to Regulation SHO.[2] We understand the Commission is seeking to be responsive to numerous requests from investors and Members of Congress that it take action to address the decline in equity prices during the eighteen months prior to the Commission's proposal. The proposed rules, however, are an inappropriate and potentially costly response to investor emotion, issuer complaints and political pressure. The Commission should not adopt the rules, unless it has empirical data showing that short selling and the lack of short sale price tests has caused or contributed to the pricing of equity securities below fundamental values and that the adoption of a short sale price test will lead to more accurate pricing of securities. Current sentiment notwithstanding, investor confidence will not be served in the long term by the adoption of rules that the Commission itself has acknowledged have no sound empirical basis and may decrease market efficiency, limit price discovery, provide less protection against upward stock price manipulations, increase trading costs, reduce liquidity and impose other potential costs on investors.[3]

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[1] CPIC is a coalition of private investment companies who are diverse in size and in the investment strategies they pursue. Established in 2005, CPIC informs policy-makers, the media and the public about the private fund industry and its role in the capital markets.

[2] *Amendments to Regulation SHO*, Exchange Act Release No. 59,748 (Apr. 10, 2009), 74 Fed. Reg. 18,042 (Apr. 20, 2009) (the "Release").

[3] *See id.* at 18,044-18,049.

I. CPIC Supports Rules That Promote Fair, Efficient Markets And Opposes Rules That Inhibit Fair Pricing.

CPIC has supported and continues to support a number of the reforms related to short selling that the Commission adopted in the past year, including elimination of the options market-maker exception to the close out requirements of Reg SHO,[4] the adoption of Rule 10b-21 making it unlawful to lie about a person's intent to deliver an equity security on or before settlement date,[5] the adoption of Temporary Rule 204T, which imposes a so-called "hard close" requirement for short sale deliveries,[6] and the adoption of Temporary Rule 10a-3T, which requires the filing of information on Temporary Form SH for the Commission's use in monitoring short sale activity.[7] These were calibrated responses to reduce the number of broker fails to deliver on short sales and to assure that the Commission has information necessary for market surveillance. Temporary Rule 204T already has significantly reduced the number of fails and thereby reduced concerns about the impact of "naked" shorting,[8] although, as the General

[4] *Amendments to Regulation SHO*, Exchange Act Release No. 58,775 (Oct. 14, 2008), 73 Fed. Reg. 61,690 (Oct. 17, 2008).

[5] 17 C.F.R. § 240.10b-21; *see also "Naked" Short Selling Antifraud Rule*, Exchange Act Release No. 58,774 (Oct. 14, 2008), 73 Fed. Reg. 61,666 (Oct. 17, 2008); *"Naked" Short Selling Antifraud Rule*, Exchange Act Release No. 57,511 (Mar. 17, 2008), 73 Fed. Reg. 15, 376 (Mar. 21, 2008); *Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments*, Exchange Act Release No. 58,572 (Sept. 17, 2008), 73 Fed. Reg. 54,875 (Sept. 23, 2008).

[6] 17 C.F.R. § 242.204T; *see also Amendments to Regulation SHO*, Exchange Act Release No. 58,773 (Oct. 14, 2008), 73 Fed. Reg. 61, 706 (Oct. 17, 2008). In brief, Rule 204T requires participants of a registered clearing agency to deliver securities on a long or short sale in any equity security by settlement date. If a participant is handling a short sale and fails to deliver on settlement date, it must purchase or borrow securities to close out the fail to deliver position by the beginning of regular trading hours on the settlement day following the day it incurred the fail to deliver position. Three days is allowed to close out long sales. A firm that fails to close out the fail to deliver position, and any broker-dealer from which it receives trades for clearance and settlement, may not thereafter, until the fail to deliver position is closed out, sell the security short, whether for itself or for another person, unless it has borrowed or arranged to borrow the security.

[7] 17 C.F.R. § 240.10a-3T; *see also Disclosure of Short Sales and Short Positions by Institutional Investment Managers*, Exchange Act Release No. 58,785 (Oct. 15, 2008), 73 Fed. Reg. 61,678 (Oct. 17, 2008). In brief, the Rule requires certain institutional investment managers to file information concerning short sales and short positions with the Commission on Form SH by the last business day of the week following any calendar week in which the manager effected a short sale.

[8] *See* Exchange Act Release No. 58,572 (Sept. 17, 2008); Exchange Act Release No. 58,166 (July 15, 2008). After implementation of Rule 204T, the number of securities with significant failures to deliver on the Reg SHO "threshold" list fell from over 400 to fewer than 20 as of March 24, 2009 — a decrease of over 95 percent. Letter from Robert Greifeld, President and Chief Executive Officer, NASDAQ OMX Group; Duncan Niederauer, Chief Executive Officer, NYSE Euronext; Joe Ratterman, Chief Executive Officer, BATS Exchange, Inc.; and Joseph Rizzello, Chief Executive Officer, National Stock Exchange to Mary Schapiro, Chairman, SEC (Mar. 24, 2009), (*available at* http://www.nyse.com/pdfs/Uptick_Letter_SEC.pdf).

Accounting Office recently reported, it also has had unintended negative consequences[9] — a product of the rushed nature of the Commission's action in adopting the rule on a temporary basis.

However, CPIC strongly opposed the Commission's emergency ban on short selling of financial stocks last fall. CPIC and other commenters warned of the consequences that came to pass: the ban harmed investors, issuers, and the markets by increasing volatility, reducing liquidity, clouding price discovery, preventing effective hedging in rapidly declining markets, severely impeding the convertible bond market, and removing short sellers as potential buyers to cushion price declines.[10] Virtually every published study and article of which we are aware reached the same conclusions.[11] In this letter, we write to urge the Commission to reject its

[9] United States Government Accountability Office, *Regulation SHO: Recent Actions Appear to Have Initially Reduced Failures to Deliver, but More Industry Guidance is Needed*, GAO-09-483, at 10, 49, 60 (May 12, 2009) (hereinafter "GAO Regulation SHO Report").

[10] For instance, in a July 21, 2008, letter to the SEC, CPIC and the Managed Funds Association jointly warned that expansion of an Emergency Order requiring short sellers of 19 designated financial institutions to borrow or arrange to borrow shares would "inflict substantial damage on the U.S. equity markets" and "result [in] market inefficiency, a reduction in liquidity, and artificially created prices resulting from regulatory burdens on the normal price discovery process." Letter from James S. Chanos, Chairman, CPIC, and Richard H. Baker, President and CEO, Managed Funds Association to Honorable Christopher Cox, Chairman, SEC, at 3-4 (June 21, 2008) (*available at* http://www.sec.gov/comments/s7-20-08/s72008-30.pdf). Beginning on September 18, 2008, the Commission nonetheless placed further restrictions on short sales, going so far as to ban short sales of all "financial" issuers, and then permitting listing exchanges to select the issuers that would be covered by the ban until its ultimate expiration on October 8, 2008, leading to the negative effects on market quality described herein. *See Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments,* Exchange Act Rel. No. 58,592 (Sept. 18, 2008), 73 Fed. Reg. 55,169 (Sept. 24, 2008); *Amendment to Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments*, Exchange Act Release No. 58,611 (Sept. 21, 2008), 73 Fed. Reg. 55,556 (Sept. 25, 2008). On October 2, 2008, the ban was extended so that it would terminate at the earlier of three business days from the President's signing of the Emergency Economic Stabilization Act ("EESA") or October 17, 2008. *Order Extending Emergency Order Halting Short Selling in Financial Stocks*, Exchange Act Rel. No. 58,723 (Oct. 2, 2008), 73 Fed. Reg. 58,994 (Oct. 8, 2008). On October 3, 2008, the President signed EESA (H.R. 1424) and the short sale ban expired on October 8, 2008.

[11] *See* Ekkehart Boehmer, Charles M. Jones, and Xiaoyan Zhang, *Shackling Short Sellers: The 2008 Shorting Ban*, (2008) (working paper) (*available at* http://www2.gsb.columbia.edu/faculty/cjones/ShortingBan.pdf); Ian W. Marsh and Norman Niemer, *The Impact of Short Sales Restrictions* (Nov. 30, 2008) (working paper) (*available at* http://www.cass.city.ac.uk/media/stories/resources/the-impact-of-short-sales-restrictions.pdf); Abraham Lioui, *The Undesirable Effects of Banning Short Sales* (Apr. 16, 2009) (*available at* http://faculty-research.edhec.com/jsp/fiche_document.jsp?CODE=1239890717080&LANGUE=1); Arturo Bris, *Short Selling Activity in Financial Stocks and the SEC July 15th Emergency Order, IMD Working Paper* (Aug. 12 2008) (available at: http://www.imd.ch/news/upload/Report.pdf); Ana Avramovic, *What Happened When Traders' Shorts Were Pulled Down?*, Credit Suisse Market Commentary (Sept. 30, 2008) (*available at* https://tradeview.csfb.com/public/bulletin/ServeFile.aspx?FileID=11181&m=-1730413896); Ana Avramovic and Phil Mackintosh, *The Blame Game: What Caused Spreads to Widen?*) (Nov. 12, 2008) (*available at* https://tradeview.csfb.com/public/bulletin/ServeFile.aspx?FileID=11354&m=1083827502); Jeff Benjamin, *Academics Slam Short-Selling Ban*, INVESTMENT NEWS (Dec. 22, 2008) (*available at* http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20081222/REG/812229981); Thomas J. Boulton and

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pending rule proposals, which we believe, based upon the studies, data and comments available to date, also will impose unjustifiable costs on investors and markets.

II. Benefits of Short Selling.

The Commission has long recognized the benefits that short selling brings to investors and the marketplace. In the release accompanying the proposed rules (the "Release"), the Commission reiterated the numerous benefits of short selling as follows:

> The Commission has long held the view that short selling provides the market with important benefits, including market liquidity and pricing efficiency. Market liquidity is often provided through short selling by market professionals, such as market makers (including specialists) and block positioners, who offset temporary imbalances in the buying and selling interest for securities. Short sales effected in the market add to the selling interest of stock available to purchasers and reduce the risk that the price paid by investors is artificially high because of a temporary imbalance between buying and selling interest. Short sellers covering their sales also may add to the buying interest of stock available to sellers.
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> Short selling also can contribute to the pricing efficiency of the equities markets. When a short seller speculates or hedges against a downward movement in a security, his transaction is a mirror image of the person who purchases the security in anticipation that the security's price will rise or to hedge against such an increase. Both the purchaser and the short seller hope to profit, or hedge against loss, by buying the security at one price and selling at a higher price. The strategies primarily differ in the sequence of transactions. Market participants who believe a stock is overvalued may engage in short sales in an attempt to profit from a perceived divergence of prices from true economic values. Such short sellers add to stock pricing efficiency because their transactions inform the market of their evaluation of future stock price performance. This evaluation is reflected in the resulting market price of the security.[12]

Numerous studies and reports confirm the benefits of short selling to investors. For example, studies have demonstrated that short selling deepens liquidity and improves market

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Marcus V. Braga-Alves, *Naked Short Selling and Market Returns* (Apr. 6, 2009) (*available at* http://ssrn.com/abstract=1373813).

[12] Release *at* 18,044 (citations omitted). The Commission used virtually identical language in its 2006 release proposing the repeal of Rule 10a-1. However, in the 2009 version, the Commission notably omits a sentence included in the 2006 release that stated: "Efficient markets require that prices fully reflect all buy and sell interest." *Amendments to Regulation SHO and Rule 10a-1*, Exchange Act Release No. 54,891 (Dec. 7, 2006) 71 Fed. Reg. 75,068, at 75,069 (Dec. 13, 2006). We hope the omission of this phrase was simply an oversight, and does not signal a departure of the Commission from its tradition of independence and neutrality on share price levels.

quality, narrowing spreads and promoting orderly buy and sell transactions.[13] Studies confirm that short selling also allows stocks to react more quickly to price-moving news.[14] Short selling also helps to keep prices for exchange traded funds ("ETFs"), derivatives, and indices properly linked to underlying security prices through arbitrage strategies.[15] It further provides investors with risk-management opportunities that lower portfolio risks. This was demonstrated between October 2007 and October 2008, when short-bias funds rose, while the Standard and Poor's 500 Index dropped.[16]

While many in the general public may see short sellers as traders with negative views on stock prices who seek to drive prices still lower through short selling, the Commission knows well that the vast majority of short sales are *market neutral*, where the seller has no view of the fundamentals of a particular company but is hedging a position in another security or other asset, or simply is locking in a spread. This occurs, for example, with buyers of convertible bonds, who short the underlying equity security as a hedge. A trader also might go long options and/or futures and then short the individual equities that comprise the corresponding index. In this case, the trader has no fundamental view of the 2,000 stocks being shorted; he simply is locking in a spread. Recent estimates by Credit Suisse indicate that only about 0.7% of hedge funds were

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[13] *See generally* Matthew Clifton and Mark Snape, *The Effect of Short-selling Restrictions on Liquidity: Evidence from the London Stock Exchange*, University of Sydney (Dec. 19, 2008) (*available at* http://www.londonstockexchange.com/about-the-exchange/regulatory/short-selling-restriction-market-quality-december-2008.pdf).

[14] *See* Pedro A. C. Saffi and Kari Sigurdsson, *Price Efficiency and Short Selling*, IESE Business School Working Paper No. 748 (Apr. 2008) (*available at* http://ssrn.com/abstract=1264939); Ekkehart Boehmer, Charles M. Jones, and Xiaoyan Zhang, *Which Shorts are Informed?*, Journal of Finance (2008) (*available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=855044; Ferhat Akbas, Ekkehart Boehmer, Bilal Erturk, and Sorin M. Sorescu, *Why Do Short Interest Levels Predict Stock Returns?*, (Mar. 10, 2008) (*available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1104850); Hazem Daouk and Anchada Charoenrook, *A Study of Market-Wide Short-Selling Restrictions*, (Feb. 2005) (*available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=687562); Jennifer Francis, Mohan Venkatachalam, and Yun Zhang, *Do Short Sellers Convey Information about Changes in Fundamentals or Risk?* (Sept. 29, 2005) (*available at* http://ssrn.com/abstract=815668); Owen A. Lamont and Jeremy C. Stein, *Aggregate Short Interest and Market Valuations* (Dec. 2003), Harvard Institute of Economic Research Discussion Paper No. 2027 (*available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=569876); Owen A. Lamont, *Short Selling Constraints and Overpricing* (2004) (available at http://www.mba.yale.edu/faculty/pdf/overpricing.pdf).

[15] *See* Ekkehart Boehmer and Julie Wu, *Short Selling and the Informational Efficiency of Prices* (Jan. 8, 2009) (*available at* http://ssrn.com/abstract=972620); Eric Kelley and Ekkehart Boehmer, *Institutional Investors and the Informational Efficiency of Prices* (Jul. 24, 2007) (*available at* http://ssrn.com/abstract=791905).

[16] Specifically, short-bias funds rose over 30 percent, compared to an approximate 36-percent drop in the Standard and Poor's 500 Index. Hedge Fund Research, Inc., *HFR Global Hedge Fund Industry Report: Special Edition* (Nov. 20, 2008) (*available for purchase* www.hedgefundresearch.com). An investor may want to hedge the risk of a long position – expecting prices to rise over time – in the same or a related security. A portfolio that includes both long and short positions of stocks will generally have lower volatility than one which only has long positions. Gene D'Avolio, *The Market for Borrowing Stock,* 66 J. Fin. Econ., 271 (Nov. 1, 2002); Bruce I. Jacobs and Kenneth N. Levy, *Enhanced Active Equity Portfolios Are Trim Equitized Long-Short Portfolios,* Journal of Portfolio Management (Summer 2007).

dedicated to short trades, while the majority of hedge funds were long only or engaged in long-short strategies.[17] Thus, the level of scorn — and blame — heaped upon fundamental or directional short sellers is wholly out of proportion to the level of their activity.

Fundamental short sellers nonetheless play an important role in price discovery. They are financial detectives, and they commit their resources to uncovering problems with companies' financial statements long before regulators discover the improper activities.[18] They are often the market watchdogs when others fail to bark. Short sellers discovered shaky accounting practices at Enron, Sunbeam Corporation, Tyco International, AremisSoft, Coleco, Boston Chicken, Baldwin United and Conseco long before the regulators did. These were not companies that short sellers destroyed in "bear raids." These were companies whose fundamentals were scrutinized by professional investors and found to be inadequate to support their market valuation.[19]

III. What Is the Harm the Commission Is Seeking to Address?

In view of the substantial benefits to investors and the capital markets provided by short sellers, the Commission, in proposing rules to impose costs and burdens on short selling, must clearly articulate, as Commissioner Kathleen L. Casey asked, "What exactly [is the Commission]

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[17] Ana Avramovic, *What Happened When Traders' Shorts Were Pulled Down?*, Credit Suisse Market Commentary at 5 (Sept. 30, 2008) (*available at* https://tradeview.csfb.com/public/bulletin/ServeFile.aspx?FileID=11181&m=-1730413896).

[18] *See e.g.*, Jonathan Karpoff and Xiaoxia Lou, *Do Short Sellers Detect Overpriced Firms? Evidence from SEC Enforcement Actions*, Working paper. 2008. University of Washington (*available at* http://ssrn.com/abstract=1102853).

> We report three findings about short selling in the stocks of firms that subsequently are identified by the SEC as having misrepresented their financial statements. First, abnormal short interest increases steadily in the 19 months before the misrepresentation is publicly revealed. The amount of this increase and the level of short interest immediately before public revelation are positively related to the severity of the misrepresentation. Second, the speed with which misrepresentation is publicly revealed is positively related to the level of short interest. And third, there is no evidence that short interest facilitates a downward price spiral when bad news hits the market. To the contrary, short selling decreases the amount by which prices are inflated by these firms' misrepresentations. Overall, this evidence indicates that short sellers anticipate the eventual discovery and severity of financial misconduct. Short selling also conveys external benefits to uninformed investors, by helping to detect financial misconduct and by keeping prices closer to fundamental values when firms provide incorrect financial information.

[19] Indeed, short sellers warned of a looming crisis in the financial markets as early as 2006. *Newsweek* recently reported that Paul Singer of Elliott Associates, "in an extraordinarily prescient analysis in September 2006 declared that the subprime mortgage securitization market was a historic scam. He correctly identified the ratings agencies as chief culprits." Michael Hirsh, *Can Hedge Funds Get Us Out Of This Mess?*, Newsweek Web Exclusive (Apr. 23, 2009) (*available at* http://www.newsweek.com/id/194893). In the spring of 2007, Mr. Chanos joined Mr. Singer in outlining to finance ministers and central bankers at a G-7 meeting the looming crisis in credit structures and overleveraged banks and brokerage firms. Unfortunately, inaction by the regulators cost millions of jobs and lost homes, trillions of dollars in investment losses and led to hundreds of billions in government spending.

trying to achieve?" More fundamentally, *what is the harm that the Commission seeks to address that is not addressed by current laws and regulations and that therefore justifies the burdens and costs of new rules?* As we read the Release, the Commission is basing this rulemaking on: (1) the potential that short selling may be used in manipulation; (2) concerns raised by issuers about a drop in prices of equity securities "unrelated to issuer fundamentals;" and (3) the loss of investor confidence based upon investors' "beliefs" about short selling and the absence of an uptick rule.

A. Concerns that short selling may be used to manipulate stock prices.

Stating that short selling "*may* be used to illegally manipulate stock prices," the Release provides as an example the "bear raid, where an equity security is sold short in an effort to drive down a security's price by creating an imbalance of sell-side interest."[20] Of course, stock prices also *may* be manipulated upward, through the placement of buy orders, the circulation of rumors and other manipulative acts. In either case, the Commission has broad antifraud authority under existing laws and rules to address fraudulent and manipulative conduct in the purchase or sale of securities.[21] The Commission has additional tools to address abusive activity in connection with short selling. For example, the Commission has a new antifraud rule to address deception relating to the delivery of a security on a short or long sale.[22] The Commission also has new temporary Rule 204T, which has significantly reduced the opportunity to use "naked" short sales in connection with an attempt to conduct a bear raid,[23] albeit with some "unintended negative consequences on security prices and securities lending" according to the GAO.[24] The Commission also has a significant amount of data on short sale activity in the Form SH reports filed under new Rule 10a-3T.[25] At minimum, the Commission must do more than point to the mere possibility of a "bear raid" as the reason for broad price tests affecting all short selling, when it has ample antifraud, regulatory and reporting tools at its disposal to address potential manipulation. The Commission should fully enforce its existing rules and explain why they are inadequate, before it adopts new rules restricting all short selling.

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[20] Release at 18044 (emphasis added).

[21] *See, e.g.*, Exchange Act Section 10(b) and Rule 10b-5 under the Exchange Act.

[22] *See supra* note 5.

[23] *See supra* note 6.

[24] GAO Regulation SHO Report at 60. The GAO's Report cited industry comments that the rule's close-out requirements have inadvertently contributed to increased market volatility and price spikes at market open. *Id at 60.* The Report also cited concerns that "the new close-out requirements are having a negative impact on the efficient operation of the securities lending market, leading potentially to reduced inventory of shares available for borrowing, increased borrowing costs, and reduced liquidity." *Id. at* 60-61

[25] *See supra* note 7.

B. Concerns that short selling may reduce share prices below fundamental values.

In providing the rationale for the rule proposal, the Commission's release states:

> [B]etween July 2007 and March 2009, the Dow Jones Industrial Average (''DJIA'') lost roughly 50% of its value, while the Standard and Poor's 500 Index fell approximately 54%. The publicly traded securities of significant financial institutions have experienced large reductions in value in 2008 and early 2009. For example, one significant financial institution's stock price declined from approximately $49 per share in the beginning of July 2007, to approximately $1 per share in March 2009. Similarly, in July 2007, another significant financial institution's stock price declined from approximately $49 per share to approximately $3 per share in March 2009.[26]

The Release states that "investors have become increasingly concerned about sudden and *excessive declines in prices that appear to be unrelated to issuer fundamentals*."[27] Yet corporate profits — in the form of the aggregate earnings of the Fortune 500 — reached their peak in *2006*, and then dropped 87% by year-end 2008.[28] In the financial services sector, which comprises roughly one-third of the Fortune 500, earnings plummeted from a positive $257 billion in 2006 to a $213 billion loss in 2008. Earnings and balance sheets collapsed, even as executives at many such companies continued to enjoy excessive compensation packages that rewarded irrational risk-taking. It is difficult to look at this situation and conclude that share price declines "appear unrelated to issuer fundamentals," and that the Commission must now impose barriers to short selling, when there is no evidence that short selling led to the collapse of share prices. The two banks that were unnamed in the Release very well could have been insolvent (and therefore their equity shares valued at zero) but for a government intervention program that has provided approximately $180 billion to the largest banks, of which $102 billion has been provided to the top two recipients.[29] Indeed, in the first quarter of 2009 there was serious public commentary about the prospects for nationalizing certain financial institutions.[30]

In fact, there is no credible data showing that short selling was the cause of the market's decline or that it caused the downfall of financial issuers such as Lehman Brothers, Bear Stearns,

[26] Release at 18,048 (footnotes omitted).

[27] Release at 18,066 (emphasis added).

[28] Shawn Tulley, *Pop! Went the Profit Bubble*, FORTUNE (Apr. 21, 2009) (*available at* http://money.cnn.com/2009/04/16/news/companies/tully_profitbubble.fortune/index.htm).

[29] *See* ProPublica, *Eye on the Bailout: Recipients* (as updated June 17, 2009) (*available at* http://bailout.propublica.org/main/list/index); *Economic Outlook: When Zero Looks Good*, United Press International (May 7, 2009) (*available at* http://www.upi.com/Business_News/2009/05/07/Economic-Outlook-When-zero-looks-good/UPI-58161241696128/).

[30] Krishna Guha and Edward Luce, *Greenspan Backs Bank Nationalisation*, The Fin. Times (Feb. 18, 2009).

IndyMac, Fannie Mae, Freddie Mac or AIG.[31] Indeed, the Release acknowledges, albeit in a footnote, that the Commission has "no empirical evidence that such falling prices are the result of short selling activity and the lack of short sale price test restrictions."[32] Moreover, the SEC's Office of Economic Analysis, in a memorandum analyzing the SEC's July 2008 Emergency Order requiring pre-borrowings for short sales, concluded that a control sample of non-financial issuers "experienced no substantive change in short interest since October 2007," a fact that "suggests that the increase in overall short interest reported by the media is driven by financial stocks and most likely the result of negative sentiment induced by the credit crisis."[33] The Commission itself, even as it proposes these new rules, admits that the price declines in the equity markets were due to long sales, noting that a study by its own Office of Economic Analysis "found that long sellers were primarily responsible for price declines" in September 2008.[34]

C. Concerns that investors have lost confidence because of their "beliefs" about short selling and the lack of an uptick rule.

The Commission's Release cites, as a rationale for reinstatement of some version of the uptick rule, the "belief" of investors who have written to the Commission that volatility and declines in the equity markets could be due to short sale activity:

> Recently, market volatility has increased markedly in the U.S., as well as in every major stock market around the world. *Although we are not aware of specific empirical evidence that the elimination of short sale price tests has contributed to the increased volatility in U.S. markets,* many members of the public currently associate the removal of former Rule 10a–1 [the uptick rule] with the recent volatility, including steep declines in some securities' prices, and the loss of investor confidence in our markets. In addition, we have received numerous requests for reinstatement of short sale price test restrictions from a variety of individuals, including investors, issuers, academics, trade associations, and members of Congress. Most of these commentators have asked that we reinstate short sale price test restrictions because they *believe* that such a measure would help restore investor confidence.[35]

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[31] One point often overlooked is the small percentage that short selling constitutes of total share volume. *See* Avramovic (Sept. 30, 2008), *supra* note 11. ("Surprisingly, although many blamed short sellers for dragging down the prices of prominent investment banks like Goldman Sachs or Merrill Lynch, their short interest was only .88 and .55, respectively, of their ADV [average daily volume] as of Sept 15 — well before the short sell limitation!").

[32] Release at 18048, n. 84.

[33] Memorandum of the SEC Office of Economic Analysis (Jan. 14, 2009) (*available at* http://www.sec.gov/spotlight/shortsales/oeamemo011409.pdf).

[34] Release at 18049.

[35] Release at 18046 (emphasis added).

We have reviewed many of the more than 5,660 letters received by the Commission thus far in its rulemaking file, and, consistent with the Commission's characterization of letters it received before the Release, most are speculative statements of belief, unsupported by facts or data. Some are identical copies of form letters, and most of the others are one or two paragraphs long. Some ask for wide-ranging reforms, such as banning short selling altogether, banning exchange traded funds, and banning program trading. Others ask simply for reinstatement of the uptick rule. None provide credible data showing that short sales or the repeal of Rule 10a-1 have harmed securities markets.

The emerging consensus from surveys on retail and institutional investors and analyses of trading patterns is that investor confidence is rebuilding, albeit in fits and starts, commensurate with economic data and political events within the U.S. and abroad.[36] This confidence is emerging without the imposition of short selling restraints.

Of course, no shareholder wants to see the price of securities he or she holds decline, whether justified by the fundamentals or not. The market decline and volatility of the period through early March of this year was bound to unsettle investors. But the foundation of investor confidence — a term used 57 times in the Commission's Release — is that the price of securities an investor buys is a fair price, and that the price is set in a market where all available information is provided by the participation of buyers and sellers, including sellers that have negative views. This type of fair pricing cannot occur where the price of a stock is influenced by the government's thumb on the scale.

IV. Short Sale Price Tests Will Impose Costs, With No Clear Benefit.

In 2007 the Commission completed an eight-year series of studies and pilot programs on the "tick test" in Rule 10a-1, including extensive data gathering and analysis by the Commission's Office of Economic Analysis ("OEA").[37] From these studies, OEA stated that it found

> little empirical justification for maintaining price test restrictions, especially for large securities. Despite changes in the displayed liquidity, all securities in the

[36] The State Street Investor Confidence Index in May 2009 rose to 106.3 from 82.1 in Fall 2008. Developed through State Street Global Markets' research partnership, State Street Associates, the State Street Investor Confidence Index measures investor confidence on a quantitative basis by analyzing the actual buying and selling patterns of institutional investors. The index is based on financial theory that assigns precise meaning to changes in investor risk appetite, or the willingness of investors to allocate their portfolios to equities. The more of their portfolio that institutional investors are willing to devote to equities, the greater their risk appetite or confidence. According to State Street's Ken Froot: "This month's [May] increase of Global Investor Confidence to 106.3 affirms the return of institutional investors to risk-taking behavior that occurred last month, after a seven-month hiatus." Press Release (May 26, 2009) (available at: http://pr.statestreet.com/us/en/20090526_1.html) (attached as Appendix A).

[37] By contrast, in the Release, the Commission asks market participants to produce data and analysis relating to five different proposals in approximately two months.

> study had about the same realized liquidity and pricing efficiency whether or not price test restrictions apply. When OEA examined the differences between large and small securities, the most interesting pattern showed that price test restrictions actually amplify volatility in large securities while dampening it in small securities.[38]

Moreover, as the Commission acknowledged:

> Because of the Commission's stated objective when it adopted Rule 10a–1 and our concerns about the potential use of short sales to manipulate stock prices, OEA examined the Pilot data for any indication that there is an association between extreme price movements and price test restrictions. OEA, however, did not find any such association.[39]

While some proponents of short sale price regulation attempt to characterize these earlier studies as flawed because they did not occur during a market decline, they overlook the fact that during the period from early 2000 to the fall of 2002, when the uptick rule was in full effect, the S&P 500 dropped from 1,527 to 777, the NASDAQ Composite Index dropped from 5,049 to less than 1,114 — almost 80 percent, and the Dow Jones Industrial Average fell from 11,723 to 7,286.[40] In any event, the findings of the Commission's earlier studies should not simply be dismissed. Rather, the Commission should undertake and publish a comparable analysis that can be subjected to review by external academics and market experts, to show that its prior conclusions were faulty.

The Commission's Release has proposed two types of price tests, which may or may not be coupled with variations of circuit breakers, and which would cover all securities (except options) listed on national securities exchanges. One price test is a modified uptick rule, which would impose a market-wide price test based on the national best bid. The modified uptick rule would be imposed either as a prohibition or as a requirement for trading centers to establish and enforce policies and procedures to prevent the execution or display of a short sale order, absent an exception, at a price that is less than the current national best bid or, if the last differently priced national best bid was greater than the current national best bid, a price that was less than or equal to the current national best bid.

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[38] *Regulation SHO and Rule 10a-1*, Exchange Act Release No. 54,891 (Dec. 7, 2006), 71 Fed. Reg. 75,068, 75,073 (Dec. 13, 2006) (footnotes omitted) (proposing repeal of Rule 10a-1 and amendments to Regulation SHO).

[39] *Regulation SHO and Rule 10a-1*, Exchange Act Release No. 55,970 (June 28, 2007), 72 Fed Reg. 36,348, 36,351 (July 3, 2007) (adopting amendments to Regulation SHO and repealing Rule 10a-1) (footnotes omitted).

[40] ROBERT E. RUBIN & JACOB WEISBERG, IN AN UNCERTAIN WORLD: TOUGH CHOICES FROM WALL STREET TO WASHINGTON, 330 (Random House Trade Paperbacks 2004). The authors note that during that period "from peak to trough some $8.5 trillion in paper wealth, of what had been a total market capitalization of almost $18 trillion, was lost. More than one thousand publicly held companies either went bankrupt or were delisted from the major exchanges." *Id.*

Alternatively, in a modified version of former Rule 10a-1, the Commission would use the last sale price as the reference point for short sale orders. Under this approach, no short sale order could be effected below the last sale price, and could be effected at the last sale price only if the last sale price is above the last different price. This Rule also could be imposed as a prohibition or in a policies and procedures format.

The release also proposes two different types of circuit breaker rules, as either an addition or an alternative to the proposed tick test restrictions, and which would only apply after declines of more than 10% in the share price of a covered security from the prior day's closing price (unless the circuit breaker was triggered within thirty minutes of the end of regular trading hours). One form of circuit breaker would, when triggered, prohibit any person from selling short that security in any market it is traded, while the circuit breaker is in effect. The other, when triggered, would impose short sale price restrictions for that security (either the national bid test or the uptick rule).

Under any of the Commission's proposals, short sales will be restricted and liquidity will diminish. While reducing the level of short sales is the goal of the Commission's proposed rules, the costs to investors will be greater. As the Commission itself has acknowledged, the proposed rules may result in a "decrease in market efficiency," a "decrease in . . . price discovery," "less protection against upward stock price manipulations," "less efficient allocation of capital," a "decrease in liquidity," "an increase in trading costs," wider spreads, shallower quote depths, and slower executions.[41] It is important to understand that the rules not only would limit short selling, they will reduce buying as well.[42]

While the proposals are less severe than an outright ban, implementation of any of the alternatives nonetheless would create impediments to short selling.[43] Evidence from the U.S. market after the imposition of the Commission's recent orders to restrict or ban short selling in financial stocks demonstrates that markets and investors will suffer unjustifiable costs.[44]

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[41] Release at 18044.

[42] *See,* e.g., Dan Mathisson, Head of Electronic Trading, Credit Suisse, Remarks before the SEC Roundtable Discussion to Examine Short Sale Price Test and Circuit Breaker Restrictions (May 5, 2009). "[W]hen you restrict short selling, whether by banning it or just by slowing it down, you're also taking away buys or slowing down buys on the other side almost in a one to one ratio." At 23 (available at http://www.sec.gov/spotlight/shortsales/roundtable050509/shortsalesroundtable050509-transcript.pdf).

[43] After all, a circuit breaker that triggers a ban on short selling a particular stock could have the same deleterious effect on market quality for the particular stock as a ban would have for a particular sector or the market as a whole.

[44] As academics and researchers found regarding the imposition of the SEC's ban on short selling financial stocks:

Liquidity Dried Up. Liquidity diminished, as buyers who usually hedged investments with short sales and other traders left the market. The Wall Street Journal noted that "[b]etween Sept. 22 and Sept. 29, overall trading volumes fell 41.1% from the week of Sept. 15-19, ... [and] volume in the restricted stocks was down 49.6%." Tom Lauricella et al., *SEC Extends "Short" Ban as Bailout Advances*, Wall St. J., Oct. 2, 2008, at C1; *see also* James Mackintosh, *Short Shrift*, Financial Times, Oct. 5, 2008.

Footnote continued on next page

As Bill O'Brien of Direct Edge explained at the Commission's recent Roundtable Discussion to Examine Short Sale Price Test and Circuit Breaker Restrictions:

> Broad restrictions on the execution of short sales without efforts to target improper conduct would have a fairly certain and significant negative effect on market operation without accompanying benefits. Studies of mature equity markets evidence that restrictions on short selling reduce trading volumes and increase transaction costs in the affected securities without preventing substantial sharp declines in asset prices. Thus, the only likely outcome of implementing these rules before the Commission is a silent tax on American investors through higher transaction costs and reduced execution flexibility, with benefits that are illusory at best.[45]

Footnote continued from previous page

Spreads Widened Dramatically. The Wall Street Journal also reported that, as may be expected from lost liquidity, spreads in restricted stocks rose sharply — from 0.15 to almost 0.40 percentage points. Lauricella, Scannell and Tracy, *supra*; *see also* Mackintosh, *Short Shrift, supra;* Louise Story, *A Debate as a Ban on Short-Selling Ends: Did It Make Any Difference?*, N.Y. Times, Oct. 8, 2008, at B8 (noting spreads on financial stocks increased by 42 percent) (*available at* http://www.nytimes.com/2008/10/08/business/08short.html?partner=rssnyt&emc=rss.)

Volatility Increased. Commentators noted the global crackdown on short selling made markets more volatile. *See* Jonathan Spicer, *Short Ban Seen Exacerbating Sharp Market Drop*, Reuters, Sept. 30, 2008, *available at* http://www.reuters.com/article/ousiv/idUSTRE48T7PT20080930. *See also* Seth Freedman, *We've Been Sold Short*, The Guardian, Oct. 17, 2008 ("The S&P 500 index lost 21.5% of its value during the period of the ban, and the embargo was viewed by market experts as actually increasing volatility in the indices.") (*available at* http://www.guardian.co.uk/commentisfree/2008/oct/17/shortselling-creditcrunch). A Nasdaq OMX study found that stocks covered by the ban became more volatile. *See* David Greising, *Short-selling ban leaves SEC with little to show*, Chicago Tribune, Oct. 10, 2008 (*available at* http://archives.chicagotribune.com/2008/oct/10/business/chi-fri-crisis-greising-shorts-oct10). The Chicago Board Options Exchange Volatility Index (a widely used measure of market volatility) set new records during the ban. *See* Jeff Kearns, *VIX Jumps to Record, Topping 56, on `Mad Rush' to Sell Assets*, Bloomberg, Oct. 6, 2008; Spicer, *supra*.

Legitimate Trading Strategies, Including Long Trades, Were Impeded. The ban severely limited the ability of traders to rely on strategies such as convertible arbitrage. According to data provider Hedge Fund Research, convertible arbitrage, which involves hedging a convertible bond purchase by shorting the underlying shares, fell by 16.3% between September 22 and September 28. *See* David Walker, *Short-Selling Is Down But Not Out As Industry Fights Back*, Dow Jones Financial News, Sept. 29, 2008. Due to the ban on short sales, there was less interest in buying convertible bonds, which tends to increase the cost of capital for issuers. *See* Alistair Barr, *Short-Sale Ban Disrupts Trades For Hedge Funds, MarketWatch*, Sept. 26, 2008, *available at* http://www.marketwatch.com/news/story/hedge-funds-suffer-short-selling/story.aspx?guid=%7BA12A0C0D-55FF-4576-9F2B-9D4C9072200E%7D&dist=msr_1).

Stock Purchases Were Hindered. The ban prevented investors from using short sales to hedge positions in financial stocks or other securities, thus discouraging them from taking on new long positions. *See* Barr, *supra*.

[45] Bill O'Brien, CEO, Direct Edge, Remarks before the SEC Roundtable Discussion to Examine Short Sale Price Test and Circuit Breaker Restrictions, 70 (May 5, 2009) (http://www.sec.gov/spotlight/shortsales/roundtable050509/shortsalesroundtable050509-transcript.pdf)

Moreover, the proposed rules will impose significant implementation and ongoing compliance costs. The Commission's release describes five different potential rule changes, so it is difficult to ascertain the costs of the potential new obligations. Nonetheless, the Commission acknowledges that after implementation of a modified uptick rule, broker-dealers would have to spend an additional $571,492,848 *every year* in ongoing compliance costs.[46]

These and other additional costs will make an already expensive investment technique more expensive, and thus deprive the markets of substantial benefits. Short selling is already a costly occupation. The market's general propensity over the years to move higher, significant lending costs, a heavy regulatory burden, comparatively unfavorable tax treatment of short-sale gains, and potentially unlimited losses combine to create what is at times a genuinely hostile environment for short sellers. Establishing and then maintaining a short position for any period of time is costly. The lender must be paid for the use of its shares. The short seller must post and continuously maintain collateral (usually in cash or high-quality government bonds) to provide security to the lender of shares. Short positions may not be short-term. The short seller may lock into the short position and wait — often for months — to cover. During this time, the short seller carries the borrowing costs, as well as the risk of upward price movement, additional collateral deposit requirements, the risk that the borrowed shares will suddenly be recalled by the lender, and even short squeeze campaigns. Thus, shorting is often a long-term position that is both costly and risky to maintain. By increasing short selling's marginal costs, the proposed rules may further discourage beneficial short selling activity.

V. The Exceptions May Swallow the Rule.

As noted earlier, the Commission acknowledges that its proposals will reduce the substantial benefits of short selling. Therefore, to ameliorate the harmful impact of its proposals, the Commission is considering numerous exceptions for certain designated types of short sale transactions. Some of these are similar to the exceptions from the temporary bans imposed on short sales of equity securities of financial companies in 2008. Thus, the Release discusses exceptions from one or more of its proposed new rules for the following types of transactions:

- *Late Deliveries on Long Sales* — where a sale order is made by a person deemed to own the security and who intends to deliver it as soon as restrictions on delivery are removed.[47]

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[46] Release at 18094.

[47] Release at 18,108 (proposed exception to Modified Uptick Rule); 18,109 (proposed exception to Uptick Rule); 18,110 (proposed exception to Circuit Breaker Halt Rule); 18,111 (proposed exception to Circuit Breaker With Modified Uptick Rule); 18,112 (proposed exception to Circuit Breaker With Uptick Rule). This exception is intended to apply where the seller is unable to deliver due to circumstances beyond their control, such as in the case of formerly restricted Rule 144 securities, or where a convertible security, option, or warrant has been tendered for conversion or exchange, but the underlying security is not reasonably expected to be received by settlement. Release *at* 18,099.

- *Errors in Marking a Short Sale* — for any sale by a broker or dealer for an account in which it has no interest, pursuant to an order marked long.[48]
- *Offsetting Odd Lot Trades by Market Makers* — for short sales by a market maker in order to offset customer odd-lot orders or to liquidate an odd-lot position.[49]
- *Domestic and International Arbitrage Transactions* — where a trade is effected for the bona fide purpose of profiting from current price differentials.[50]
- *Over-Allotments and Lay-Off Sales* — for short sales by underwriters or similar broker-dealers in connection with an over-allotment or a lay-off sale in connection with a distribution through rights or a standby underwriting commitment.[51]
- *Transactions on a Volume-Weighted Average Price (VWAP) Basis* — for short sales effected in VWAP transactions.[52]
- *Electronic Trading Systems* — for sales effected through electronic trading systems that match buying and selling interest at various times throughout the day, at independently derived prices.[53]
- *Riskless Principal Transactions* — for transactions where a broker or dealer effects a short sale in order to effect a customer purchase or customer "long" sale at the same price (exclusive of fees).[54]

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[48] Release at 18,109 (proposed exception to Uptick Rule); 18,112 (proposed exception to Circuit Breaker With Uptick Rule).

[49] Release at 18,108 (proposed exception to Modified Uptick Rule); 18,109 (proposed exception to Uptick Rule); 18,111 (proposed exception to Circuit Breaker With Modified Uptick Rule); 18,112 (proposed exception to Circuit Breaker With Uptick Rule).

[50] Release at 18,108 (proposed exception to Modified Uptick Rule); 18,109 (proposed exception to Uptick Rule); 18,111 (proposed exception to Circuit Breaker With Modified Uptick Rule); 18,112-18,113 (proposed exception to Circuit Breaker With Uptick Rule).

[51] Release at 18,108 (proposed exception to Modified Uptick Rule); 18,109 (proposed exception to Uptick Rule); 18,111 (proposed exception to Circuit Breaker With Modified Uptick Rule); 18,113 (proposed exception to Circuit Breaker With Uptick Rule).

[52] Release at 18,108 (proposed exception to Modified Uptick Rule); 18,109 (proposed exception to Uptick Rule); 18,112 (proposed exception to Circuit Breaker With Modified Uptick Rule); 18,113 (proposed exception to Circuit Breaker With Uptick Rule).

[53] Release at 18,109 (proposed exception to Uptick Rule); 18,113 (proposed exception to Circuit Breaker With Uptick Rule).

[54] Release at 18,108 (proposed exception to Modified Uptick Rule); 18,109-18,110 (proposed exception to Uptick Rule); 18,111-18,112 (proposed exception to Circuit Breaker With Modified Uptick Rule); 18,113 (proposed exception to Circuit Breaker With Uptick Rule).

- *Market Maker Executions at Offered Prices Following a Trade-Though* — for certain sales by a specialist, registered exchange market maker, or third market maker for its own account effected at a price equal to its most recent offer communicated if such offer, when communicated, was equal to or above the last reported regular way sale.[55]

- *Executions By Non-Market Makers at Offered Prices Following a Trade-Though* — for certain sales by any broker-dealer, whether acting for its own account or for any other person, effected at a price equal to the broker's most recent offer, in an amount less than or equal to the quote size of such offer if the offer, when communicated, was above the last reported regular way sale, or equal to the last such sale price if that last sale price was above the next preceding different price.[56]

- *Facilitation of Customer Buy Orders* — for sales by a registered market maker or specialist publishing two-sided quotes to facilitate customer market or marketable limit buy orders.[57]

- *After Hours Trading* — short sale restrictions would not apply when quotations or last sale prices are not disseminated.[58]

- *Bona Fide Market Making Activities By Market Makers and Options Market Makers* — for registered market makers, block positioners or other market makers obliged to quote in the OTC market.[59]

- *Assignment to Call Writers Upon Exercise of an Option* — for sales by any writer of a call option due to assignment after exercise by the holder.[60]

- *Bona Fide Market Making in Derivatives* — for sales by any market maker, including an OTC market maker, as part of bona fide market making and hedging related directly to (i) derivative securities based on that security; or (ii) ETFs and Exchange-Traded Notes of which that security is a component.[61]

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[55] Release at 18,110 (proposed exception to Uptick Rule); 18,113 (proposed exception to Circuit Breaker With Uptick Rule).

[56] Release at 18,110 (proposed exception to Uptick Rule); 18,113 (proposed exception to Circuit Breaker With Uptick Rule).

[57] Release at 18,110 (proposed exception to Uptick Rule); 18,113 (proposed exception to Circuit Breaker With Uptick Rule).

[58] Release at 18,108 (proposed exception to Modified Uptick Rule); 18,110 (proposed exception to Uptick Rule); 18,110 (proposed exception to Circuit Breaker Halt Rule); 18,111 (proposed exception to Circuit Breaker With Modified Uptick Rule); 18,112 (proposed exception to Circuit Breaker With Uptick Rule).

[59] Release at 18,110 (proposed exception to Circuit Breaker Halt Rule).

[60] Release at 18,110 (proposed exception to Circuit Breaker Halt Rule).

[61] Release at 18,110 (proposed exception to Circuit Breaker Halt Rule).

- *Last 30 Minutes of the Trading Day* — short sale restrictions would not be triggered in the last 30 minutes of the trading day.[62]
- *Options and Futures Contract Expiration* — for short sales that occur after the automatic exercise or assignment of options held before a short selling halt is imposed when the option expires, and to allow short sales that occur after expiration of futures contracts held before a short selling halt is imposed.[63]

In addition to the exceptions reflected in the text of the various proposed rules, the release inquires whether the following additional types of short sale transactions should also be excepted, in one form or other, from the proposed rules:

- Transactions at the daily opening of trading at each trading center, the opening of trading after a trading halt, or for the close of trading at each trading center.[64]
- Short sale orders that are not pursuant to "regular way" contracts.[65]
- Transactions effected in after-hours crossing sections at closing prices.[66]
- Hedging of convertible securities and convertible arbitrage in the case of a halt triggered by a circuit breaker.[67]
- Transactions effected through "upstairs customer facilitation."[68]
- Transactions by parties conducting delta-neutral hedging.[69]
- Transactions by parties involved in index arbitrage transactions.[70]

Participants at the recent Roundtable also urged the Commission to adopt exceptions for short sales effected in connection with the following types of transactions or trading strategies:

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[62] Release at 18,110 (proposed exception to Circuit Breaker Halt Rule); 18,111 (proposed exception to Circuit Breaker With Modified Uptick Rule); 18,112 (proposed exception to Circuit Breaker With Uptick Rule).

[63] Release at 18,110 (proposed exception to Circuit Breaker Halt Rule).

[64] Release at 18,074 (potential exception to Modified Uptick Rule), 18,077 (potential exception to Uptick Rule).

[65] Release at 18,074 (potential exception to Modified Uptick Rule).

[66] Release at 18,076-18,077 (potential exception to Uptick Rule).

[67] Release at 18,080 (potential exception to Circuit Breaker Halt Rule).

[68] Release at 18,082 (potential exception to Circuit Breaker Price Test Rule).

[69] Release at 18,082 (potential exception to Circuit Breaker Price Test Rule).

[70] Release at 18,082 (potential exception to Circuit Breaker Price Test Rule).

- Hedged derivatives transactions.[71]
- Transactions in index ETFs and ETFs in general.[72] Interestingly, a recent GAO report stated that, as of December 2008, about 50 percent of the securities on the threshold list (reflecting persistent failures to deliver and short sales) were ETFs.[73]
- Transactions in convertible securities.[74]
- Transactions by hedged traders that are not market makers.[75]
- Transactions by "high frequency traders," who may or may not be registered market makers.[76] In this connection, one participant in the Commission's recent Roundtable estimated that perhaps 2/3 of all market activity is accounted for by such trades.[77]

After carving out various types of short sale activity in order to make a harmful rule less harmful, the Commission may be left with short sale restraints that apply only to a small percentage of short sales — primarily short sales that are strategic, truly directional and based on the short seller's view that an issuer's share price is overvalued. These are the very trades that "inform the market of their evaluation of future stock price performance" and which the Commission repeatedly has said provide substantial benefits to investors.[78] Even if the Commission were targeting only those short sellers with fundamentally negative views on issuers, it begs the question as to why the Commission would require markets to shoulder enormous compliance and implementation costs, and why the Commission is willing to devote its scarce regulatory and compliance resources, to address such a small portion of short selling activity.[79]

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[71] *See* Dan Mathisson, Head of Electronic Trading, Credit Suisse, Remarks before the SEC Roundtable Discussion to Examine Short Sale Price Test and Circuit Breaker Restrictions, 24 (May 5, 2009) (*available at* http://www.sec.gov/spotlight/shortsales/roundtable050509/shortsalesroundtable050509-transcript.pdf).

[72] *See* John Nagel, Deputy General Counsel and Head of Global Compliance, The Citadel Group, Remarks before the SEC Roundtable Discussion to Examine Short Sale Price Test and Circuit Breaker Restrictions, 99 (May 5, 2009); Remarks of Dan Mathisson, *supra, note* n. 71.

[73] GAO Regulation SHO Report, *supra* note 9, at 7.

[74] *See* Remarks of Dan Mathisson, *supra*, note 71, at 47-48.

[75] *See* Remarks of Dan Mathisson, *supra*, note. 71, at 48.

[76] *See* Justin Schack, Vice President for Market Structure Analysis, Rosenblatt Securities, Remarks before the SEC Roundtable Discussion to Examine Short Sale Price Test and Circuit Breaker Restrictions, 29-30 (May 5, 2009).

[77] *Id.*

[78] Release at 18,044. *See also Amendments to Regulation SHO and Rule 10a-1*, Exchange Act Release No. 54,891 (Dec. 7, 2006) 71 Fed. Reg. 75,068, 75,069 (Dec. 13, 2006).

[79] While some of the exceptions put forward by the Commission and others have a sound basis, others simply reflect the effectiveness of various participants in making their case to exclude certain transactions. In any event, the Commission, before adopting such an exception-laden rule, should develop and review information regarding the percentage of short sale activity that would be covered under each of the proposed exemptions.

In view of the important "watchdog" role played by fundamental short sellers in committing their financial resources to ferreting out the Enrons, Tycos and Sunbeams in the marketplace, the Commission should include a further exemption for short sales that are effected pursuant to a bona fide fundamental analysis of a company's business practices and financial status.

In any event, if the Commission does implement exception-laden short sale restrictions, its inspection staff will be burdened with retracing transactions to discern which were eligible for exceptions, which were not, and if any were disguised — a mind numbing task.

VI. Conclusion.

In a recent paper analyzing the effect of the 2008 short selling bans, Finance Professor Abraham Lioui of the Ecole des Hautes Etudes Commerciales ("EDHEC") had the following observation, which speaks equally to the Commission's stated purpose in the rulemaking of imposing burdens on short-selling in the name of investor confidence:

> [I]t is our hope that the regulatory authorities do not intend to influence market movements. Doing so has never been part of the regulatory mission. The loss of credibility that would accompany mistakes could have catastrophic consequences.[80]

This is the first major rulemaking by the Commission in response to a financial crisis that brought us to the brink of a global financial meltdown. For a crisis of such magnitude, the Commission, as the sole Federal agency tasked with protecting the investor, could have stepped in to lead a wide-ranging "special study" of the causes of the crisis. Yet, instead of conducting such a study, or even acknowledging other potential causes of market declines in its rulemaking release, the Commission has decided instead, in the words of Captain Renault in *Casablanca*, to "round up the usual suspects" — the short sellers.[81]

There are always those who only support free markets when stocks ascend and then prefer intervention during price corrections and a return to rational values. Adopting policies that threaten the existence of deep and liquid securities markets has profound implications, not only for short sellers but for the integrity of our markets. When the U.S. government intervenes by taking unjustified actions to support stock prices, investors who buy at those inflated prices will certainly be the losers.

Removing information from the markets — whether it be by posing barriers to short selling or by rolling back mark-to-market accounting standards — as a means to promote

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[80] Abraham Lioui, "The Undesirable Effects of Banning Short Sales" at 18 (EDHEC Risk and Management Research Centre, April 2009) (*available at* http://faculty-research.edhec.com/jsp/fiche_document.jsp?CODE=1239890717080&LANGUE=1).

[81] *See* Appendix B.

"investor confidence" is terrible precedent. We note that regulators are under pressure, but we urge the Commission to carefully review the evidence, and place the burden of proof upon those who advocate placing new burdens and costs on short selling.

As stated by Nobel economics laureate Gary Becker last fall, "[t]he temporary banning of short sales is an example of a perennial approach to difficulties in financial markets and elsewhere; namely, 'shoot the messenger.' Short sales did not cause the crisis, but reflect beliefs about how long the slide will continue."[82] Amity Shlaes, author of *The Forgotten Man: A New History of the Great Depression*, has observed that one of the parallels between the recent past and that of 80 years ago is that "they had a witch-hunt against their short sellers in the early 1930s just as we have a lot of pressure on the short sellers now."[83] We hope that a second parallel to the 1930s does not develop: one where economic recovery is slowed by refusal to recognize true causes and continued blame on the messengers.

For the Commission's further information, we have attached Appendix A, "Investor Confidence Survey," and Appendix B, "A Brief Review of Efforts to Curtail Short Selling."

We thank you for this opportunity to provide our comments. We would be happy to discuss them with you at your convenience.

Sincerely,

James S. Chanos
Chairman
Coalition of Private Investment Companies

[82] Gary S. Becker, *We're Not Headed for A Depression*, Wall St. J., Oct. 7, 2008 (*available at* http://online.wsj.com/article/SB122333679431409639.html). In Appendix B, we briefly review prior efforts to restrict short selling and some of the repeated confirmations of its beneficial effects.

[83] "Morning Joe," MSNBC, Oct. 13, 2008. Ms. Shlaes is a syndicated columnist for Bloomberg and a Senior Fellow at the Council on Foreign Relations.

cc: The Honorable Luis A. Aguilar, Commissioner
The Honorable Kathleen L. Casey, Commissioner
The Honorable Troy A. Paredes, Commissioner
The Honorable Elisse B. Walter, Commissioner
Elizabeth M. Murphy, Secretary
James Brigagliano, Acting Director
Division of Trading and Markets
Daniel Gallagher, Acting Director
Division of Trading and Markets
Andrew J. Donohue, Esq., Director
Division of Investment Management

Appendix A

Investor Confidence Survey

The State Street Investor Confidence Index® measures the attitude of investors to risk. Developed by Harvard Professor Ken Froot and State Street Associates Director Paul O'Connell, the Index uses the principles of modern financial theory to model the underlying behavior of global investors. Unlike other survey-based confidence measures that focus on expectations for future prices and returns, the Index provides a quantitative measure of the actual and changing levels of risk contained in investment portfolios representing about 15% of the world's tradable assets. (Available at: http://www.statestreet.com/industry_insights/investor_confidence_index/ici_overview.html).

INVESTOR CONFIDENCE INDEX RISES FROM 103.2 TO 106.3 IN MAY

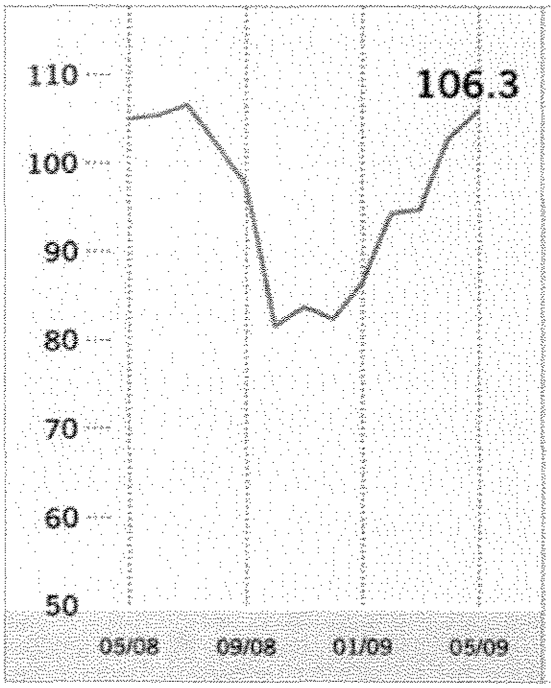
Boston, May 26, 2009 – State Street Global Markets, the investment research and trading arm of State Street Corporation (NYSE:STT), today released the results of the State Street Investor Confidence Index® for May 2009.

Global Investor Confidence rose by 3.1 points from the revised April reading of 103.2. Confidence was up strongly in North America, where the benchmark rose 9.6 points from 95.3 to 104.9. Confidence also rose robustly among European investors, climbing 7.5 points from 76.8 to 84.3. However, risk appetite diminished somewhat in Asia, falling 4.9 points from 98.0 to 93.1.

Developed through State Street Global Markets' research partnership, State Street Associates, by Ken Froot and Paul O'Connell, the State Street Investor Confidence Index measures investor confidence on a quantitative basis by analyzing the actual buying and selling patterns of institutional investors. The index is based on financial theory that assigns precise meaning to changes in investor risk appetite, or the willingness of investors to allocate their portfolios to equities. The more of their portfolio that institutional investors are willing to devote to equities, the greater their risk appetite or confidence.

"This month, we have revised the Investor Confidence Index to provide a better guide as to the level of risk tolerance," said Froot. "Specifically, we have rebased the Index so that a level of 100 is 'neutral': readings above this level tell us that institutional investors are increasing their allocations to risky assets, while readings below 100 indicate that institutional investors are reducing such allocations. This month's increase of Global Investor Confidence to 106.3 affirms the return of institutional investors to risk-taking behavior that occurred last month, after a seven-month hiatus."

"Looking across the regions, the rebasing of the Investor Confidence Indices this month provides a new lens through which to view risk appetite," added O'Connell. "While the risk tolerance of North American investors has increased to the point where they are adding to their portfolios of risky assets, the same cannot be said of European and Asian investors, who, while more confident than in past months, remain cautious."



Investor Confidence Index

Period: May 2008 – May 2009

Previous month:	103.2
Current month:	106.3
Change:	▲ 3.1
12-month high:	107.0
12-month low:	82.1

Global:	106.3	Europe:	84.3
		Change:	▲ 7.5
N. America:	104.9	Asia-Pacific:	93.1
Change:	▲ 9.6	Change:	▼ 4.9

Appendix B

A Brief Review of Efforts to Curtail Short Selling

There is an element of déjà vu in the Commission's latest proposal to impose burdens on short selling. Some variation on this theme becomes politically expedient every time the market takes a major correction. Following the crash of 1929, the first congressional proposals for market regulation were aimed primarily at restricting short selling.[1] One proposal went so far as to require imprisonment of short sellers. While the claims of short-sale critics were convincingly rebutted by the writings of their contemporaries,[2] the attacks on short selling continued.[3]

Indeed, most historical efforts to restrict short selling have failed, due to a lack of empirical evidence. As former SEC Commissioner Irving Pollack observed in his 1986 report *Short-Sale Regulation of NASDAQ Securities*, "the early attempts to prohibit short sales did not withstand the test of time, and short sales gradually came to be recognized as essential to the efficient functioning of securities markets."[4] To that end, the United States government and its regulators, since the beginning of the last century, have recognized the important role played by short sellers in U.S. markets and steadfastly rejected efforts to prohibit the practice.

The Commission periodically has reexamined its position on short selling, but the results have consistently been the same: short selling is good for the markets, and critics' complaints are unfounded. Numerous studies have borne out this finding.[5]

For example, Congress examined short selling as part of its investigation into the market crash of 1987, and again, not only was short selling exonerated, it was identified as a valuable tool for U.S. securities markets. During congressional hearings in November of 1989, the Director of the Commission's Division of Market Regulation told Congress that short selling "provide[s] the market with two vital

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[1] JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET, 9 (Houghton Mifflin 1982).

[2] For example, New York Stock Exchange economist Edward Meeker published *Short Selling* in 1932, in which he sought to debunk the myth that bear traders were to blame for the 1929 market crash. Meeker's research concluded that there was no indication that bear raids contributed to the collapse, that short interest in the market at the time of the crash was minimal (approximately 0.01% of outstanding shares), and that large block sales and forced sales by margin traders were more likely to blame for the market's fall. *Id.*.

[3] Even before the 1929 crash, efforts were made to curtail short selling. During World War I, the New York Stock Exchange (NYSE) imposed special short-sale regulations amidst fears that agents of the Kaiser would attempt to drive down stock prices. *The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Entities of the H. Comm. on Fin. Services*, 108th Cong. 116 (2003) (statement of Owen A. Lamont, Assoc. Prof. of Fin., Graduate Sch. of Bus., Univ. of Chicago) (*available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_house_hearings&docid=f:89633.pdf).

[4] IRVING M. POLLACK, SHORT-SALE REGULATION OF NASDAQ SECURITIES, 20 (1986).

[5] Studies were conducted in 1935 and 1951 by the Twentieth Century Fund, and in 1937, 1963, and 1976 by the Commission. Pollack's report summarized the findings of the 1935 study: "The study found that, in general, short selling does not have any appreciable effect in limiting the extremes to which prices may rise. Its tendency is to accelerate the downward trend in prices during the early and middle phases of movements and either check the price trend in the lower phase or heighten its movement after prices have turned upward. However, the study found that considered in terms of long positions and total trading, short sales ... have not been in sufficient volume to warrant the belief that their actual effect is at all material.'" *Id.* at 30.

benefits: market liquidity and pricing efficiency."[6] The Associate Director of the Commission's Enforcement Division also commented on short sale complaints. While confirming that the Commission had taken "appropriate enforcement action" in instances where short sales had been "used as a means to achieve an illegal end," he observed that short sellers were often the discoverer, and not the perpetrator, of the illegal behavior:

> [T]he Commission has found occasions where short sellers have detected corporations which are engaged in violations of the securities and other laws themselves in order to inflate the value of their securities. When we have sustainable evidence of this type of violation, we will bring that case as well.[7]

Mr. Sturc also emphasized that the Commission "frequently find[s] that the complaints of downward manipulations that we receive from issuers or their affiliates do not lead to sustainable evidence of violations of the antifraud provisions of the federal securities laws."[8] Members of the industry also testified as to the benefits of short selling and cautioned against sweeping changes to short sale regulation.[9]

In 2003 hearings, Congress conducted another review of short selling amid allegations by certain groups that short sellers and plaintiffs lawyers were sharing information in order to drive down the stock of companies.[10] These allegations were effectively rebutted by Professor Owen Lamont of Yale University, who testified that his research showed

> [W]hen you have these fights against short sellers and firms, short sellers are usually vindicated by subsequent events. Firms that take anti-shorting actions tend to have falling prices in the following years, suggesting that they were overpriced to begin with, perhaps due to fraud by management; perhaps just due to excessively optimistic investor expectations.

"Short sellers," he opined, "are good at detecting and publicizing fraud on the part of firms. . . . To protect investors, we need a vibrant short seller community."[11]

Moreover, at the same hearing, Congressman Paul Kanjorski noted the vital role that short sellers play as the free market's own defense against hype and outright fraud:

> That is part of the free market methodology of cleaning our markets.... [W]e cannot depend that government or regulators are always going to be able to keep everybody on

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[6] *Short-Selling Activity in the Stock Market: The Effects on Small Companies and the Need for Regulation: Hearing Before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the H. Comm. on Government Operations*, 101st Cong. 385 (1989) (statement of Richard G. Ketchum, Dir., Div. of Market Regulation, SEC).

[7] *Id.* at 392 (statement of John H. Sturc, Assoc. Dir., Div. of Enforcement, SEC).

[8] *Id.* at 434.

[9] *See, e.g., id.* at 216 (statement of Edward Kwalwasser, Senior V. P., Regulatory Group, NYSE) ("[T]he NYSE believes short selling, properly regulated, offers many legitimate benefits to investors, the marketplace and the economy in general.").

[10] *The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk: Hearing before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Entities of the H. Comm. on Fin. Services*, 108th Cong. 28-30 (2003) (statement of Paul Kamenar, Senior Executive Counsel, Washington Legal Foundation).

[11] *Id.* at 34 (statement of Owen Lamont).

> the top and narrow. . . . I think having companies that have a gag rule on everything and can perpetuate all kinds of frauds would be worse than having a short selling operation. . . . If enough people know about it in your company and it is going to leak out, and you are going to get raided in a short sale, that is your problem. That is good enforcement. That is the capitalist market. You got stuck. We did not have to spend one cent for a prosecutor. We did not have to send the FBI down. We did not have to do anything. You just got cleaned.[12]

In 2007 the Commission completed an eight year series of studies and pilot programs on the "tick test" of Rule 10a-1, including extensive data gathering and analysis by the Commission's Office of Economic Analysis ("OEA"). The OEA concluded that there was "little empirical justification for maintaining price test restrictions, especially for large securities."[13]

The Commission's rulemaking resulted in the repeal of Rule 10a-1 in July 2007. Since that time, until its emergency actions in 2008 and its proposal to impose new price tests, the Commission's efforts with respect to short sale regulation have been focused primarily on ensuring that broker-dealers meet their delivery obligations at settlement,[14] or on other conduct related to covering transactions,[15] and not on price-based regulation.

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[12] *Id. at* 46-47 (statement of the Honorable Paul Kanjorski).

[13] *Amendments to Regulation SHO and Rule 10a-1*, Exchange Act Rel. No. 54,891 (Dec. 7, 2006) 71 Fed. Reg. 75,068, 75,073 (Dec. 13, 2006) (footnotes omitted) (proposing repeal of Rule 10a-1 and amendments to Regulation SHO).

[14] *See e.g., Amendments to Regulation SHO*, Exchange Act Rel. No. 56, 212 (Aug. 7, 2007) 72 Fed. Reg. 45544 (Aug. 14, 2007) (eliminating Reg SHO's exception to close-out requirements for fails to deliver that occurred before the security reached "threshold" levels); *"Naked" Short Selling Antifraud Rule*, Exchange Act Rel. No. 58,774 (Oct. 17, 2008) 73 Fed. Reg. 61,666 (Oct. 14, 2008) (approving Rule 10b-21, which prohibits deception relating to the delivery of a security on a short or long sale); *Amendments to Regulation SHO*, Exchange Act Rel. No. 58,775 (Oct. 14, 2008) 73 Fed. Reg. 61,690 (Oct. 17, 2008) (eliminating Reg SHO's exception from close-out requirements for options market-makers).

[15] *See e.g., Short Selling In Connection With A Public Offering,* Exchange Act Rel. No. 56,206 (Aug. 6, 2007) 72 Fed. Reg. 45,094 (Aug. 10, 2007) (amending SEC rules that forbid certain manipulative acts in connection with stock offerings, to prohibit a person who sells short during an offering's restricted period to purchase securities in that offering (even if shares purchased in the offering are not used to cover).