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June 19, 2009

Ms. Elizabeth Murphy  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, D.C. 20549-1090

**Re: Comment on Proposed Amendments to Regulation SHO  
File No. S7-08-09**

The International Swaps and Derivatives Association, Inc. ("ISDA") appreciates the opportunity to comment on the Proposed Amendments to Regulation SHO (the "Release") of the Securities and Exchange Commission (the "Commission").

ISDA, which represents participants in the privately negotiated derivatives industry, is among the world's largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985, and today has over 825 member institutions from 57 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Information about ISDA and its activities is available on the Association's web site: [www.isda.org](http://www.isda.org).

Our members support the Commission's goal of preventing abusive or manipulative short selling activity, such as "bear raids" and "naked" short selling. We applaud the Commission's recent actions to prevent naked short sales, in particular Interim Final Temporary Rule 204T of Regulation SHO ("Rule 204T") and Rule 10b-21 under the Securities Exchange Act of 1934 (the "1934 Act"). As noted by the SEC's Office of Economic Analysis, Rule 204T has been successful in decreasing the average daily number of aggregate fails to deliver for all securities from 1.1 billion to 582 million for a total decline of 47.2% when comparing a pre-Rule to post-Rule period.<sup>1</sup> We believe that

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<sup>1</sup> Memorandum from OEA Re: Impact of Recent SHO Rule Changes on Fails to Deliver (Mar. 20, 2009), available at <http://www.sec.gov/comments/s7-30-08/s73008-107.pdf>.

making Rule 204T permanent will curb harmful short selling and will address the Commission's goal of fostering investor confidence. This goal is further bolstered by the Commission's recent adoption of Rule 10b-21 under the 1934 Act, which makes clear that any person who deceives a broker-dealer, participant of a registered clearing agency or purchaser about its intention or ability to effect settlement on a short sale has violated the antifraud provisions of the federal securities laws.

We believe that further restricting short sales would introduce inefficiencies into markets, reduce liquidity, impair price discovery and impede capital formation by discouraging the many types and uses of short selling that are beneficial to the marketplace. Short selling is a critical component of the equity derivatives markets, which play an important role in capital formation, risk management and market liquidity. For example, when used as a part of an arbitrage strategy, short selling by investors or listed and OTC derivatives dealers add significantly to the liquidity and price transparency of issuers' offerings of convertible and exchangeable bonds. Similarly, short selling is essential to the functioning of the listed and OTC equity derivatives markets, allowing investors, derivatives dealers and issuers to manage the equity price risks in their investment strategies, businesses and offerings. For example, short selling allows market participants to provide principal protection in an investment portfolio, tailor the exposure of an equity investment to an investor's particular risk profile, reduce the volatility of a derivatives dealer's overall portfolio or reduce the potential dilution of a convertible offering.

Additional restrictions on short selling would have a negative impact on the efficient operation of these markets. For example, options valuation models – the tools that market participants use to value and hedge equity derivatives transactions that are options or contain embedded options – assume the ability to continuously trade in the underlying stock, including through short sales. Equity options are often hedged by dealers and these hedges are typically adjusted according to these models throughout the term of the transaction. Even the least severe restrictions on short selling will make it harder to value options correctly, leading to unwillingness on the part of traders to buy and sell options. If the restrictions are more severe, such difficulty could lead to a freeze in options trading.

If, however, the Commission concludes that additional restrictions on short selling are necessary, we believe that certain basic exceptions to such restrictions, which we describe below, are necessary. These exceptions would be necessary regardless of the nature of the restrictive rule adopted and, as a result, we refrain from comparing in detail the five alternative forms of short sale restrictions proposed by the Commission or expressing a preference for any particular type of restriction.<sup>2</sup> Our proposed exceptions

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<sup>2</sup> We do pause to note, however, that we believe that the Release's contemplation of a circuit breaker trigger of a 10% decline in the price of a stock is too restrictive. ISDA members believe that the percentage of price decline triggering a circuit breaker should be tied to the level of the stock price. Otherwise, lower-priced stocks would be unfairly subjected to more trading interruptions than higher-priced stocks.

would be tailored to achieve the policy goals outlined above while minimally impeding market liquidity and capital raising. In addition, we believe it is very important that any short selling restriction be fairly and uniformly applied across derivatives markets (i.e., the listed option and OTC derivatives markets) to avoid regulatory arbitrage.

In this regard, we welcome the March 2009 Consultation Report of the IOSCO Technical Committee's Task Force on Short Selling. The report articulates four high level principles to guide global short selling regulations, including that "short selling regulation should allow appropriate exceptions for certain types of transactions for efficient market functioning and development." Because *bona fide* hedging, market making and arbitrage activities "generally provide benefits to the market and are unlikely to pose risks that will destabilise the market," the Report recommends that short sale regulation include flexibility for these activities where appropriate.

### **Basic Exceptions to Any Short Sale Restriction**

ISDA believes that the Commission should adopt certain basic exceptions to any short sale restriction the Commission promulgates. While we recognize that their precise formulation will be driven by the form of restriction, exceptions should permit (a) OTC derivatives dealers and other market participants to engage in *bona fide* hedging of net long positions; (b) underwriters and selling stockholders to engage in short sales registered by the issuer of the stock under the Securities Act of 1933 (the "1933 Act"); (c) OTC derivatives dealers and issuers of structured products to dynamically adjust short positions that hedge pre-existing transactions; and (d) OTC derivatives dealers and issuers of structured products to engage in short sales of all or substantially all of the individual stocks composing a broad-based index or basket as a *bona fide* hedge of a structured product linked to such index or basket.

***An Exception for Bona Fide Hedges of Net Long Positions.*** ISDA believes that any adopted short sale restriction should include an exception for short sales entered into as part of a *bona fide* hedge of a net long position. Holders of long positions will not engage in "bear raids" or otherwise sell short to drive down, or accelerate the decline of, the market price for a stock and then profit from the price drop that they helped create. The existence of a net long position in the short seller's portfolio removes any profit motive from the short position as any such profit will be offset by the loss in the net long position. In contrast to a bear raider, the holder of a net long position uses short sales to economically insulate himself from losses resulting from a drop in the market price of the security.

Under our proposed exception, a "net long position" would consist of (a) ownership (within the meaning of Rule 200(b) of Regulation SHO) of at least an equivalent amount of securities of the same class as those being shorted (a "physical long position") or (b) a long economic exposure to the securities on a delta-adjusted basis resulting from a derivative transaction or instrument or chain of derivative transactions or instruments entered into

directly or indirectly with (i) the issuer of the underlying securities or (ii) a third party or third parties with a physical long position in the securities.

The term “derivative transactions or instruments” as used in clause (b) above would explicitly include any security that is convertible into or exchangeable for, or the value, exercise, payout or settlement of which is linked to the value of, the underlying security. Therefore, this exception would permit short sales executed as part of a convertible arbitrage strategy, whether as the initial hedge or dynamic adjustment of a preexisting hedge position and whether as a market maker or as another market participant. The primary responsibility for compliance with this exception would fall on the derivative counterparty seeking to enter into the derivative transaction with a *bona fide* market maker. We believe this party is in the best position to evaluate and evidence the availability of the exception.<sup>3</sup> Dealers would be under an obligation to inform customers of this restriction and the exception, including informing customers of the triggering of a circuit breaker, but would not be under any obligation to make inquiries or record responses of the customers. In contrast, we believe that the exception to the circuit breaker halt rule for *bona fide* market making in derivative securities, as proposed in the Commission’s Release, has significant limitations. For example, it is unclear whether the writer of an individually negotiated, bilateral, nontransferable OTC derivative would constitute a “bona fide market maker in derivative securities.” It is also unclear whether the issuer of a structured product or its affiliate would constitute such a market maker, particularly if it is not at the time actively making a market in those notes but instead hedging its exposure to the notes. It is also unclear which derivative instruments would be considered “derivative securities.” In addition, while the proposed exception for certain “bona fide arbitrage” explicitly includes convertible arbitrage, as written it would not apply to hedging of most convertible securities that are now customary in the market. The exception would not cover “cash settled” or “net share settled” convertibles. It would be available only for convertibles that are immediately convertible (i.e., it does not cover contingent or European-style convertibles). In addition, the exception as written would not be applicable to the circuit breaker halt rule.

***An Exception for Registered Short Sales.*** We propose an exception for underwriters and selling stockholders to engage in short sales registered by the issuer of

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<sup>3</sup> This exception has elements similar to the approach to short sales taken by the UK Financial Services Authority in October 2008. Such an approach may be worth revisiting in lieu of restrictions aimed exclusively at short sales.

Also note that, because derivatives dealers typically hedge on a book-wide and not a transaction-by-transaction basis, not all short derivatives entered into by customers will result in a hedging short sale by the derivatives dealer. For example, when an OTC derivatives dealer enters into a derivative that, if hedged on a transaction-by-transaction basis would require a short sale, the OTC derivatives dealer might be net long the underlying shares on a book-wide level. The OTC derivatives dealer would then be in a position to hedge the new customer transaction by reducing its book-wide long position (i.e., selling long), rather than selling short. Therefore, this sale would not be subject to short sale regulation at all. Obviously, this will be the case whether or not there is an exception available for *bona fide* hedging of net long positions.

the stock under the 1933 Act.<sup>4</sup> In recent years, there have been a variety of capital raising and hedging transactions involving short sales registered with the Commission under the 1933 Act. For example, issuers, affiliates or holders of large stakes of restricted securities have engaged in forward or option-based contracts of the types described in the interpretive letter of the Office of Chief Counsel of the Division of Corporate Finance to Goldman, Sachs & Co. dated October 9, 2003.<sup>5</sup> In other transactions, companies have established registered "stock borrow facilities" in connection with offerings of convertible or exchangeable securities. These transactions generally involve an OTC derivatives dealer entering into a privately negotiated derivative transaction with an issuer, affiliate or holder of restricted securities and hedging its exposure to the derivative by selling shares short in a transaction that is registered on a Form S-3 registration statement or other appropriate form. Because secondary equity offerings by issuers and affiliates often occur below current market prices, it is particularly important that such transactions have an exception from short sale restrictions.

Such registered short sales occur with the consent, cooperation and participation of the issuer. In the case of issuer transactions, the issuer benefits directly from the registered short sales. In the case of third party transactions, the issuer benefits indirectly since the registration may only be made pursuant to registration rights granted by the issuer after a determination that such registration is in the best interests of the company. Registered short sales are also similar to syndicate short sales made in connection with underwritten offerings. Therefore, registered short sales would not involve abusive short sales or bear raids and do not constitute the type of activity that short sale regulation is intended to address.

***An Exception for Dynamic Adjustments of Pre-existing Hedge Positions.***

We believe that OTC derivative dealers and structured product issuers should be assured that they will be able to continue to dynamically adjust pre-existing hedge positions with additional short sales, as necessary. Without such an exception, dealers and issuers would be exposed to unpredictable potential discontinuities in their hedging that would be very difficult to model and could cause severe economic losses.

OTC derivatives dealers engage in two distinct types of hedging short sales with respect to options-based derivatives: (i) initial short sales to establish the basic hedge position and (ii) dynamic adjustments during the term of the option. An OTC derivatives dealer that wishes to hedge a derivative position through short sales of the underlying security will establish an initial hedge position by selling short the number of underlying shares determined by the OTC derivatives dealer's risk management and option valuation models. In the case of option-based derivatives, subsequent to establishing its initial short position, the OTC derivatives dealer is likely to need to dynamically adjust this position by

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<sup>4</sup> It is unclear whether the exception proposed by the Commission in the Release for "bona fide arbitrage" would cover registered short sales by dealers through stock loan facilities entered into in connection with convertibles, because such short sales are often executed by dealers against long swap positions entered into with buyers of the convertibles.

<sup>5</sup> Goldman, Sachs & Co., SEC No-Action Letter (Oct. 9, 2003).

effecting additional short sales and purchases of the underlying security so as to remain in a delta-neutral position. These additional transactions are necessary to respond to changes in certain market factors, such as the price, volatility and dividend rates of the stock and prevailing interest rates.<sup>6</sup> These dynamic adjustments would not involve the type of abusive shorting that short sale regulation would be designed to prevent because generally they are determined by the application of algorithmic delta hedging models.

If derivatives dealers are not confident that they will be able to manage their risk exposure by dynamically adjusting pre-existing hedge positions, they will be less willing to trade in the listed and OTC derivatives markets. The resulting decrease in liquidity of and demand for these products will largely remove from the market tools used for capital formation and risk management, thereby detrimentally affecting the financial markets as a whole.

***Expanded Exceptions for Bona Fide Hedges of Index- and Basket-Linked Structured Products and OTC Derivatives.*** Index- and basket-linked structured product and OTC derivatives provide investors, including retail investors, with tailored exposure to securities markets while benefiting from various combinations of weighted market participation and capital protection. The ability of OTC derivatives market makers and issuers to engage in continuous short sales of all or substantially all of the stocks underlying the index or basket is necessary for a liquid market in such products. For example, certain “reverse index notes” which have been a common offering of structured products issuers provide investors with an enhanced yield if the final value of an index is below its initial value. In a “bull index note,” an investor receives an enhanced yield if the index to which it is linked appreciates. The issuer of such notes would typically hedge its exposure directly or indirectly through short sales of all the component securities of the index. If a short sale restriction were to be put in place, even if only a single share of a stock in the index or basket were subject to a short sale restriction, absent an exception, the entire basket effectively would be subject to short sale restrictions.

So long as the component securities constitute a relatively small portion of the overall index or basket, it is extremely unlikely that short sales of all or substantially all the component of the index or basket would be used as a tool to drive down the price of an individual stock in an abusive manner. For example, bear raiders would be unlikely to use the S&P 500 index as a tool by which to effect a bear raid on an individual stock within that index. What constitutes a “relatively small portion” of an index or basket for this purpose depends on the index or basket being hedged.

Accordingly, we would propose the following tiered approach to an exemption for short selling of all or substantially all the components of indices and baskets, including

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<sup>6</sup> For a further discussion of dynamic hedging in the OTC derivatives context, see Letter from Luke Farber, Chairman, Derivatives Products Committee, Securities Industry Association to Jonathan G. Katz, Secretary, Securities and Exchange Commission, File No. S7-23-03 (Feb. 19, 2004); Letter from Patricia Maher et al. to Jonathan G. Katz, Secretary, Securities and Exchange Commission, File No. S7-07-97 (May 22, 1997).

those forming the assets of exchange traded funds (“ETFs”). Short sales in a stock effected to hedge a basket or index would be exempted from any short sale restriction if (a) the index being hedged is on an enumerated list of public, widely disseminated and frequently linked indices including the Dow Jones Industrial Average, MSCI North America, NASDAQ-100, Russell 1000, Russell 2000, Russell 3000, S&P 100, S&P MidCap 400, S&P 500 and S&P SmallCap 600 and any total return version of the foregoing;<sup>7</sup> (b) the stock, as of the trade date of the structured product or OTC derivative, constitutes no more than 10% of any other independent third-party sponsored index or basket; or (c) the stock constitutes no more than 5% of a proprietary index or basket sponsored by the issuer (or an affiliate) of the structured product or OTC derivative.<sup>8</sup>

In addition, we propose that there be an exception for short selling of ETFs. ETFs allow investors to gain exposure to a variety of indices, including equity indices, without requiring the investor to purchase each individual stock that composes the index and therefore raise all the same issues discussed above in connection with indices and baskets. In addition, it is essential to the operation of ETFs that they closely track the net asset value (“NAV”) of its underlying stocks. Arbitrage activity ensures that ETFs trade at or near NAV by allowing arbitrageurs to sell the underpriced asset, either the ETF or its components, until equilibrium is restored. Short sale restrictions would act as an impediment to this essential arbitrage activity by limiting an arbitrageur’s ability to sell the overvalued asset. The Commission has held in numerous contexts that short sales of ETFs do not implicate the harmful bear raid concerns that short sale rules are meant to address.<sup>9</sup>

## Conclusion

By focusing on timely delivery of short sales, ISDA believes that Rule 204T and Rule 10b-21 have been effective in curbing short sale abuses. Conversely, regulations focused on restricting short selling activity (whether through a price test or an outright ban triggered by a circuit breaker) would introduce inefficiencies into markets, reduce liquidity, impair price discovery and impede capital formation. In order to prevent such adverse results, ISDA believes it is essential that the Commission adopt certain basic exceptions for the derivatives markets if the Commission ultimately decides to adopt additional restrictions on short selling. Therefore, we urge the Commission to adopt the proposed exceptions outlined above.

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<sup>7</sup> This list is not intended to be exhaustive. ISDA would be willing to provide additional comments on developing a more comprehensive list and methodology for updating the list from time to time.

<sup>8</sup> We would recommend as standards for indices falling into this category (i) any index approved by the Commission pursuant to Securities Exchange Act Rule 19b-4 as an underlying index for listed options or structured products or (ii) any index that satisfies the Narrow Based Index for listed options (see [generally Securities Exchange Release No. 51256 \(Feb. 25, 2005\)](#)) or the Generic Listing Standard for index linked securities. (Securities Exchange Act Release No. 51563 (Apr. 15, 2005)).

<sup>9</sup> See, e.g., Exemptive Relief for Exchange Traded Index Funds, SEC No-Action Letter, File No. TP 00-133 (Aug. 17, 2001) (granting an exemption from Rule 10a-1 to permit short sales of “all ETFs trading on any registered national securities exchange that have obtained Rule 19b-4(e) listing approval from the Commission” without regard to the “tick” requirements of Rule 10a-1); Select Sector SPDRs, SEC No-Action Letter, File No. TP 98-326 (Dec. 14, 1998) (granting the same exemption from Rule 10a-1 for sales of Sector SPDR Fund Shares).

Due to the complexity of the short sale proposals presented in the Commission's Release, we strongly urge the Commission to submit any proposed rule in a release for further public comment. The opportunity to comment on a single proposed rule with enumerated exceptions would allow interested parties, such as ISDA, the ability to focus their analysis on the rule's details. In addition, if the Commission determines to adopt a short sale price test, we strongly urge the Commission to do so on a limited pilot basis to assess the purported benefits of the restriction and its impact on the markets. Furthermore, should the Commission adopt a restriction, it should give adequate implementation time, which we believe will far exceed the three months suggested in the Release.

Should you have any questions concerning the foregoing, please feel free to contact the undersigned.

Respectfully submitted,



Katherine Tew Darras  
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