CFA INSTITUTE | Centre for Financial Market Integrity

21 August 2009

Elizabeth Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

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

Dear Ms. Murphy:

The CFA Institute Centre for Financial Market Integrity (the "CFA Institute Centre")[1] appreciates the opportunity to comment on the U.S. Securities and Exchange Commission's proposed amendments to Regulation SHO that impose restrictions on short selling and would require broker-dealers to mark certain sell orders "short exempt" when relying on an exemption under the proposed rules.

Executive Summary

We support short selling as a legitimate investment activity that provides a number of benefits to the financial markets. We do not, therefore, support either permanent or temporary bans of short selling such as those imposed on the markets during the fall of 2008.

We believe that the SEC's repeal of price test restrictions in 2007 contributed to the market volatility seen over the past year, and therefore favor imposition of restrictions if they safeguard the markets from future sweeping bans. If the SEC decides to go this route, we strongly urge measured testing through a pilot program before permanently adopting the restriction.

If the SEC decides to impose short selling restrictions, we support the concomitant requirement on broker-dealers to mark their orders when relying on an exemption.

---

[1] The CFA Institute Centre for Financial Market Integrity is part of CFA Institute, a global, not-for-profit professional association of 97,600 investment analysts, advisers, portfolio managers, and other investment professionals in 135 countries, of whom 85,490 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

Charlottesville New York Hong Kong London
560 Ray C. Hunt Drive
PO Box 3668
Charlottesville, VA
22903-0668 USA
434 951 5499 tel
434 951 5262 fax
info@cfainstitute.org
www.cfainstitute.org

Discussion

We support the deliberative process undertaken by the SEC to now address whether restrictions on short selling should be reintroduced. Given its long and varied history, the issue of short selling and the scope of freedom it should be allowed to assume deserve a careful and studied analysis.

General Support of Short Selling

As a threshold issue, we want to reiterate our longstanding support of short selling. Both in the U.S. domestic market and in Europe, we have recognized short selling as a legitimate investment activity and one that serves a number of useful purposes for the financial markets. Among these benefits are improvements to the markets' price determination mechanisms, leading to more pricing efficiency, narrower bid-ask spreads, and greater market liquidity.[2]

We also recognize, however, that short selling is open to certain abuses, including the ability of speculators to move the market in ways that create market imbalances. Overall, we believe that the benefits to the markets and investors outweigh the detriments of short selling, as long as meaningful measures are enforced to control manipulative activities. We also do not support the practice known as abusive naked short selling, and have encouraged means designed to protect the investor from this practice.[3]

Effect on Investor Perception

We appreciate the thoughtful research done by the SEC's Office of Economic Analysis and others relating to the effects on the markets of short selling and leading to the SEC's repeal of Rule 10a-1 in July of 2007. We note the discussion in the Release that the large number of studies conducted by OEA and others found little correlation between short selling and market volatility prior to repeal, including the lack of empirical evidence justifying short selling price restrictions. A number of studies since, however, tend to suggest a positive correlation.

While we believe the repeal of the up-tick rule in 2007 contributed to the subsequent market volatility, we also note that a number of unprecedented market factors also contributed to volatility. The bankruptcy of Lehman Brothers, the receivership of the two large mortgage GSEs, federal bailouts of banks and insurance companies, and the extraordinary steps taken by markets regulators worldwide against short selling all may have played a role in the unprecedented levels of price volatility and momentum. Because these factors make the links between short selling and market volatility difficult to accurately assess, we urge a slow and thorough reevaluation of possible policy responses.

Regardless of the various findings, market events over the last 16 months have raised a number of issues that defy, or may not be supported by, empirical evidence. A critical issue has been the apparent loss of investor

---

[2] *See e.g.,* article by James Allen, CFA, "Don't Sell Short Selling Short," (CFA Magazine, Nov-Dec 2009); February 5, 2003 comment letter to Margot Marshall (Financial Services Authority) from James. C. Allen, CFA and Frederic Lebel, CFA (Discussion Paper 17—"Short Selling" (Ref. FSA DP 17).

[3] *See* June 17, 2208 comment letter from Kurt N. Schacht, CFA and Linda L. Rittenhouse to Nancy Morris ("Naked" Short Selling Anti-Fraud Rule, File. No. S7-08-08) (advocating elimination of the regulatory "safe harbor" that allows broker-dealers to rely on the assurances of sellers and instead suggesting that broker-dealers bear the ultimate responsibility for covering securities that fail to settle on time or within a reasonably proscribed time period after the date of delivery).

confidence and the best ways to restore it. As recognized by the SEC and other commentators, many investors attribute, in some part, the most recent market volatility to seemingly contradictory reasons, including the repeal of the uptick rule in 2007, the additional restrictions on short selling in July 2008, and the suspension of short selling activity in certain sectors in September 2008, whether or not this can be supported by empirical evidence. Thus, one means of strengthening investor confidence at a critical time in the recovery of the markets may be in restoring a system that was seen as working to reduce volatility.

There are a number of ways to bolster investor confidence in a system that has suffered a number of crises. While we support efforts to improve investor confidence, we do not support the kinds of bans on short selling that were introduced during the fall of 2008, which we believe amounted to an unjustified and detrimental response to market volatility at that time. Rather, we would support imposing restrictions on short selling such as those proposed by the Commission as preferable to a system that remains vulnerable to such future bans.

Should the SEC decide to move forward with the implementation of one of the options discussed in its proposal, we strongly recommend that it be adopted on a pilot basis before deciding on a permanent rule adoption.

CFA Institute Survey

In May 2009, CFA Institute surveyed 19,988 of its members on short selling. More than 1,500 responded to the survey. Of those who responded, 89% either agreed or strongly agreed that short selling benefits the market by providing price discovery and market liquidity, with 50% of U.S. respondents *strongly agreeing*.[4]

The perceived loss of investor confidence due to changes in short selling was strongly reaffirmed in this survey. Specifically, 74% of U.S. respondents either strongly agreed or agreed that repeal of the uptick rule in the U.S. markets as the main check and balance on short selling contributed to market volatility in the shares of financial services firms.

With respect to the various options provided in the proposal, a plurality of CFA Institute members–42% of U.S. members and 38% of members globally–expressed support of a market-wide permanent uptick rule based on the last sale price. In many cases, however, the second-favored option was an up-tick rule based on the national best bid. Consequently, even though our membership found a rule based on the last sale preferable, we believe that these survey results indicate that our members would support, or at least would not strongly object to, a decision by the Commission to use an up-tick rule based on the national best bid.

Finally, we support the proposed requirement that a broker or dealer would have to mark sell orders as “long”, “short”, or short-exempt”. This type of information provides meaningful information to both the institutions lending the stock and to market regulators.

---

[4] The survey posed five questions, including asking respondents to choose one of the options presented in the proposal. The survey did not provide the context in which these options were being considered or any discussion of underlying factors being considered by the SEC. This survey had a response rate of 7.1 percent with a margin of error of + or – 2.6 percent.

Conclusion

While we believe that short selling should be allowed, we are not adverse to the imposition of price test restrictions, if the SEC ultimately concludes that they will contribute to market stability without undermining the fundamental benefits of short selling. Before taking such action, however, we urge use of a measured pilot program to test out various scenarios under differing market conditions.

Should you have any questions about our positions, please do not hesitate to contact Kurt N. Schacht, CFA at kurt.schacht@cfainstitute.org or 212.756.7728; or Linda L. Rittenhouse at linda.rittenhouse@cfainstitute.org or 434.951.5333.

Sincerely,

/s/ Kurt N. Schacht

Kurt N. Schacht, CFA
Managing Director
CFA Institute Centre for
Financial Market Integrity

/s/ Linda L. Rittenhouse

Linda L. Rittenhouse
Director, Capital Markets Policy
CFA Institute Centre for
Financial Market Integrity