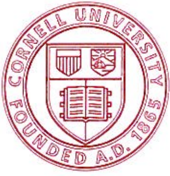

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The Honorable Christopher Cox
Chairman
United States Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments; Release No. 34-58572

Dear Chairman Cox:

The Cornell Securities Law Clinic (the "Clinic") welcomes the opportunity to comment on the above-referenced rule proposal (the "Rule Proposal"). The Clinic is a Cornell Law School curricular offering in which second and third-year law students have the opportunity to provide representation of public investors and public education as to investment fraud in the largely rural "Southern Tier" region of upstate New York. See http://securities.lawschool.cornell.edu.

1. The Clinic Supports The Rule Proposal.

The Clinic supports the Rule Proposal as it creates further disincentives for market participants to engage in naked short selling. Instituting new penalties for close-out violations while expanding the application of short selling rules to previously exempted entities furthers the public interest. More specifically, the Rule Proposal imposes penalties where short sellers and their broker-dealers fail to deliver securities by the close of business on the settlement date. The settlement date is three days after the sale transaction date (commonly referred to as T + 3) and delivery of the securities is considered to close-out the trade. If the securities are not delivered at such time the trade is not closed out and the trader is in a "fail to deliver position." Such a fail to deliver position gives rise to the various penalties described in the Rule Proposal in addition to those penalties already in effect. Under the current Rule 203(b)(3), an options market maker is exempted from Regulation SHO's close-out requirement. The Rule Proposal will amend Rule 203(b)(3) to eliminate this exemption and thus subjects "options market maker[s]" to the proscriptions and penalties of Regulation SHO. The Clinic supports these changes as effective measures to curtail naked short-selling.

The Clinic would also like to take this opportunity to note that the broader implications of regulating short selling should be considered when drafting prohibitions on naked short selling. Short selling plays an important role in the market and as such it

should be preserved. Notably, a naked short sale does not become an illegal naked short unless the trade fails to close out within three days or the trader deceptively enters a sale order with no intention or ability to deliver by the settlement date. With respect to the former situation it is important that the benefits of short selling be properly considered lest the punishments for failing to close be made too severe thereby deterring entrants from the legitimate short sale market. Not all failures to close are the result of bad intent; sometimes unforeseeable events simply prevent the proper closing of the trade. Participants in the short market will be too hesitant to engage in trades if they fear substantial liability should such an unforeseeable event occur. As a result, the legitimate short sale market may diminish. Thus, regulations such as the Rule Proposal should carefully seek to accomplish the goal of preventing abusive practices while remaining cognizant of what effect the regulations may have on other legitimate markets.

This comment addresses below the policy concerns that should be taken into account before the Proposed Rule is finalized and leaves to the drafter's judgment the best means carrying these considerations into action.

The Clinic recognizes no benefit to the average public investor, pecuniary or otherwise, in allowing naked short selling. Intentional naked shorting on a large scale is a market manipulation technique that serves no proper valuation purpose. It's availability to only large market traders means that often the realized costs will come at the expense of ordinary market traders. These manipulations are further obscured by the lack of market transparency. This leaves the average market trader with little chance of adapting their trading practices in light of such artificial price fluctuations simply because they are unaware of the fluctuations true cause.

However, the Clinic cautions the SEC to take careful consideration of the possibly beneficial role that traditional short selling can play in the market before enacting any regulations which may directly or indirectly affect it. This involves careful attention to the benefits of preserving the short sale market while narrowly tailoring solutions to prevent abusive practices within it. Illuminated below are some of the arguments made in support of preserving the short sale market. Lastly, this comment includes some cautionary notes that the SEC should consider before undertaking action in response to heightened public pressure calling for increased regulation and market transparency.

2. Short Selling May Help Prevent Market "Bubbles"

Short sales play a market role where investors legitimately believe that a company is currently overvalued in the market. Securities in a company may be overvalued for a number of reasons and may be trading at prices that do not have a sound basis in theory or actuality. These artificially high prices have been seen to result from the "irrational exuberance" of investors, a term coined by Alan Greenspan, whereby investors unduly escalate asset values because of unfounded speculation. Allowing a market for short selling can help realign security prices with the actual worth of the company. If effective in this realignment task, short selling provides a tool to stave off substantial losses that can occur when overinflated markets collapse, i.e. when the "bubble bursts."

Elimination of short sales is seen by some as artificially propping up the markets by eliminating a force that in a free market would drive prices down. Since the markets are not driven down the eventual drops, if and when they do occur, are sharper than they would otherwise have been because the market was artificially inflated. According to Dwight M. Jaffee, a business professor at the University of California, Berkeley:

> "The problem is that we believe that markets perform a process of "price discovery"—determining the proper price for each security. It does this by aggregating the information of all market traders. If you rule out one class of traders—short sellers—you could create an upward bias in the prices. This may not be harmful in the short run, but if left in place it could lead to grossly inefficient resource misallocations."[1]

Short traders serve the additional important function in the market of putting pressure on weak companies to strengthen themselves or be acquired, thereby aligning management's interests with those of the shareholders.

3. <u>Short-Selling Can Increase Market Efficiency</u>

The argument has further been made that banning short-selling will adversely affect the stock market's efficiency by reducing liquidity and making it harder to settle on appropriate prices. "[T]he ban on short-selling may prolong the crisis . . . in the sense that it will now take the markets longer to adjust to the true values of financial companies."[2] That means investors should think twice before buying shares of any companies for which short-selling is now banned. This investor doubt or reluctance could translate into its own set of difficulties in the market place.

4. <u>Market Transparency May Not Be the Answer</u>

Disclosure of short positions, particularly of large market players such as hedge funds, should be given careful consideration. For example, a lag time between disclosure to the SEC and public dissemination of that disclosure should be adequate to allay certain concerns. First, investment groups (much like individuals) have various techniques for valuation of securities. A sufficiently long lag time would ensure that the data disclosure would not compromise a hedge fund's intellectual property. Second, it could cause enormous unintended consequences should other investors copy-cat shorts made by hedge funds. Because hedge funds expend tremendous amounts of time and money in valuing companies, often developing their own proprietary trading strategies, lay investors may be quick to pile into a hedge fund's short position. This could put further downward pressure on share prices and result in rapid or excessive devaluation of a

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[1] New York Times, Thoughts on Short-Selling, September 18, 2008. Available at http://topics.blogs.nytimes.com/2008/09/18/thoughts-on-short-selling/?scp=3&sq=shortsell&st=cse

[2] New York Times, Maybe Short-Selling Isn't So Bad, After All, September 27, 2008 (quoting Adam Reed, a finance professor at the University of North Carolina at Chapel Hill who has extensively studied short-sellers' behavior and its effects on the markets)

security. Thus, increased transparency on who is shorting what securities and to what extent may not be the best way to prevent market deflation.

Disclosure is often made of long positions which in theory may give rise to the same copycat concerns. However, belief that a company will continue to experience growth is much more prevalent than that a particular company is vastly overvalued at present. Additionally, the long market is significantly larger than the short market so an influx of investors is much less likely to have as drastic of effects on price. Thus, securities are not as likely to become overvalued by disclosure of long positions of prudent investors as they are to become undervalued by disclosure of short positions.

5. Empirical Evidence May Not Support Drastic Action

Although the Clinic does not support naked shorting as a matter of principle there is inadequate empirical evidence to justify overreaching regulations of short selling under the guise that it is necessary to curb rampant abuses. A recent New York Times article has evaluated short sellers' behavior.[3] Quoted in that article are the recent findings of studies conducted by Arturo Bris[4] and Adam Reed. Both experts analyzed short-sellers' behavior in the months before the rash of recent S.E.C. actions. Excerpts of their main points are listed below:

- Each day, the exchanges publish a list of stocks for which there has been even a very small number of failures to deliver. In recent months the large financial stocks have hardly ever appeared on those lists.
- "In recent years when academic researchers have looked for bear raids—even in those areas in which investors suspected that they existed—they haven't found them." A close study of 19 beleaguered financial stocks for which the SEC. restricted short sales between July 21 and Aug 15 concluded that the poor performance of those 19 stocks in the year leading to that action "cannot be attributed to short-selling activities." One telling statistic was the so-called short-interest ratio, which is calculated by dividing the number of shares held short by the average daily trading volume. On average, those 19 stocks had short-interest ratios that were no higher than those of other financial stocks in the year leading up to the SEC policy change. What is more, while the SEC restrictions were in place, these stocks, on average, actually performed worse than the rest of the market.
- There is also reason to believe that short sellers were not the impetus behind the recent downturn in securities values. For example, what short-sellers did on Sept. 9, a day that rumors circulated widely about a possible bankruptcy at Lehman Brothers and Lehman's stock fell 45 percent, to $7.79 from $14.15. According to Professor Bris, the average price at which short-sellers sold Lehman stock that day was $9.29, significantly closer to the day's low than to the high. That implies

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[3] New York Times, Maybe Short-Selling Isn't So Bad, After All, September 27, 2008.

[4] Arturo Bris is a finance professor at IMD, the Swiss business school, who also is a research fellow at the Yale International Center for Finance

that they were reacting to the downward momentum, not causing it. Typically, Professor Bris said, "short-sellers trade in response to past negative news, rather than inducing current stock price drops."

Conclusion

As set forth above, the Clinic generally supports the Rule Proposal. Shaping prophylactic measures involves appropriately tailoring punishments to both the magnitude and breadth of the abuses they seek to prevent. To this end the Clinic hopes that proper regard will be given to the possible effects of future regulation so that other important markets are preserved.

Respectfully submitted

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