



December 15, 2008

VIA Electronic Mail: rule-comments@sec.gov

Ms. Florence E. Harmon
Acting Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Amendments to Regulation SHO, Interim Final Temporary Rule; S7-30-08

Dear Ms. Harmon:

Managed Funds Association (“MFA”)¹ appreciates the opportunity to comment on the Securities and Exchange Commission’s (“SEC” or “Commission”) interim final temporary amendments to Regulation SHO (the “Rule 204T”) under the Securities Exchange Act of 1934 (the “Exchange Act”), issued in Release No. 34-58773 (the “Release”).²

I. INTRODUCTION

The economic crisis has created extraordinary market challenges in the last six months for regulators and market participants. The Commission has taken the unusual step of instituting a series of emergency orders under section 12(k)(2) of the Exchange Act to implement immediate regulatory action to address manipulative short selling.³ Market participants did not have an opportunity to comment on the emergency orders prior to implementation. As a result, the

¹ MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately \$1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

² 73 FR 61706 (Oct. 17, 2008).

³ Emergency Order to Enhance Investor Protections Against Naked Short Selling, Exchange Act Release No. 58572 (Sept. 17, 2008); SEC Order Requiring Institutional Money Managers to Report New Short Sales, Exchange Act Release No. 58591 (Sept. 18, 2008); SEC Order Halting Short Selling in Financial Stocks, Exchange Act Release No. 58592 (Sept. 18, 2008) (“SEC Order Halting Short Selling”); SEC Order Easing Restrictions on Issuers to Re-Purchase Their Securities, Exchange Act Release No. 58588 (Sept. 18, 2008); Amendment to SEC Order Requiring Institutional Money Managers to Report New Short Sales, Exchange Act Release No. 58591A (Sept. 21, 2008); Amended Order Halting Short Selling in Financial Stocks, Exchange Act Release No. 58611 (Sept. 21, 2008); Amendments to Regulation SHO, Exchange Act Release No. 58773 (Oct. 14, 2008); Disclosure of Short Sales and Short Positions by Institutional Investment Managers, Exchange Act Release No. 58785 (Oct. 15, 2008).

emergency orders had certain unintended adverse consequences and costs, and may have created market dislocations.⁴

MFA believes that it is important for the Commission to have the authority to address extraordinary market circumstances by instituting emergency measures. MFA stands ready to assist the Commission under such circumstances. Nevertheless, under normal market conditions we believe it is imperative for rulemaking to follow the notice, comment and analysis process set forth under the Administrative Procedure Act to minimize unintended consequences and unnecessary costs, and to provide adequate time for market participants to adjust to any new regulatory requirements. MFA also believes that the Commission should invoke its emergency powers as narrowly as possible. Markets thrive on predictability. When the Commission suddenly and unexpectedly imposes emergency orders, it inevitably introduces an element of regulatory risk and uncertainty, which discourage market participation, thereby inhibiting trading and reducing needed liquidity. We also note that under Section 3(f) of the Exchange Act, in considering or determining whether an action is necessary or appropriate in the public interest, the Commission must consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

As the Commission reviews the efficacy of Rule 204T and Reg SHO, we believe it would be beneficial to issuers and investors for the Commission to provide to the public an analysis of the market impact of Rule 204T and a summary of the SEC and the Financial Industry Regulatory Authority's investigations over the last several years on broker-dealers' compliance with Reg SHO. Market participants would benefit from meaningful analysis detailing the frequency of non-locates, fails to deliver and the proportion of fails to deliver that are attributable to an exception to Rule 204T and Reg SHO in understanding the extent of any "naked" short selling problem. We believe information on the Commission's efforts to enforce compliance with Reg SHO and analysis on the impact of Rule 204T and Reg SHO would also help restore confidence in our financial markets, as well as provide quantitative data upon which future regulation can be based.⁵

II. COMMENTS

Short selling, as the Commission recognizes, provides the market with at least two important benefits: market liquidity and pricing efficiency.⁶ MFA believes it is important that the Commission's effort to address "naked" short selling does not restrict legitimate short selling. The Commission has not defined "naked" short selling but has generally referred to it as "short selling without having securities available for delivery and intentionally failing to deliver

⁴ See Short Selling Activity in Financial Stocks and the SEC July 15th Emergency Order, Arturo Bris, IMD, European Corporate Governance Institute and Yale International Center for Finance, August 12, 2008 (hereinafter "July 15th EO Study").

⁵ See also MFA's recommendation for the Commission to review the effects of Rule 10a-3T in a letter from Stuart J. Kaswell, Executive Vice President and General Counsel, Managed Funds Association, to Florence E. Harmon, Acting Secretary, Securities and Exchange Commission, dated Dec. 15, 2008.

⁶ Regulation SHO Proposing Release, Exchange Act Release No. 48709 (Oct. 28, 2003), 68 FR 62972 (Nov. 6, 2003).

securities within the standard three-day settlement cycle.”⁷ MFA as a policy matter does not condone naked short selling.

Short sale regulation that is overly restrictive impairs market liquidity and capital-raising among issuers by making it harder for investors to borrow securities and invest on the long side. Short selling is a critical risk management tool and an essential component of a wide range of *bona fide* cash and derivatives hedging strategies that enables investors to provide liquidity to the financial markets. Generally, a fund’s risk management system and/or trading strategy will not allow the fund to increase its long positions if it is not adequately hedged. Take, for example, the decision to buy a convertible bond, which is an important manner by which companies, including distressed companies, seek to raise capital. Most investors in convertible bonds seek to hedge their market risk by shorting stock to maintain a sufficient “delta” hedge. Under such a strategy, when the price of the underlying security goes up, owners of convertible bonds sell short to hedge their exposure, and when the price of the underlying security goes down, they buy shares of the security to cover short positions and limit volatility to the down side. Similarly, the same dynamic occurs with respect to volatility strategies and option volatility positions, where participants attempt to cover short positions when prices fall and sell short when prices rise. Limiting an investor’s ability to manage the risk of their long investments through short positions, similarly limits investors’ their ability to invest on the long side of the market and provide public companies with necessary funding and market liquidity.

MFA members have strong incentives to prevent failures to deliver from occurring. Securities that fail to deliver are disruptive to a fund’s trading program because they interfere with a fund’s risk management calculation and introduce another layer of uncertainty—the risk of being closed-out. In addition, a fund is likely to face significant operational difficulties when a security fails to deliver, including a potentially lengthy trade reconciliation process, the task of updating its books and records, the impairment of voting rights, friction with its prime broker and the uncertainty and risk of a costly buy-in. Funds that conduct algorithmic trading strategies may place thousands of orders per minute with a broker-dealer.⁸ It would be very costly and operationally burdensome for such a fund to reconcile its trades and update its books and records, among other things, if its clearing broker closes out a large number of the trades placed with it.

A. Regulation SHO

Rule 204T proposed short sale rules should be based upon the Reg SHO framework. We commend the Commission for the thoughtful, deliberative process it employed in developing Reg SHO and believe that improved trading practices and controls have resulted therefrom. Securities

⁷ Regulation SHO Final Amendments, Exchange Act Release No. 56212 (Aug. 7, 2007), 72 FR 45544 (Aug. 14, 2007) (“2007 Regulation SHO Final Amendments”); Regulation SHO Proposed Amendments, Exchange Act Release No. 54154 (July 14, 2006), 71 FR 41710 (July 21, 2006) (“2006 Regulation SHO Proposed Amendments”); Regulation SHO Adoption Release, Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008, 48009 n.10 (Aug. 6, 2004) (“2004 Regulation SHO Adopting Release”).

⁸ The advent of algorithmic trading has enriched our financial markets by adding even more depth and liquidity to our markets. As previously explained, algorithmic traders may buy and sell thousands of securities a minute, injecting the market with liquidity as they trade. A consequence of the July 15th Emergency Order was that algorithmic traders had to switch from automated trading to manual trading, a more timely and inefficient way of trading. This limited the amount of liquidity such traders were able to provide to the market.

firms and investors have made considerable investments in operational systems and controls to comply with Reg SHO.

Reg SHO has benefited investors by providing a regulatory framework that creates greater market stability, market liquidity and investor confidence. In developing Reg SHO, the Commission focused on modernizing short sale regulation to maintain the benefits of short selling while minimizing naked short selling and failures to deliver. The Commission engaged in studies, investigations and reviews of the efficacy of Rule 10a-1, the “Uptick Rule” before concluding that it was ineffective and repealing it. The Commission worked with various investor and industry groups to understand the dynamics of short selling and the clearing and settlement process before implementing a uniform standard specifying the procedures for all short sellers to locate securities for borrowing. As a result of the Commission’s deliberative process in developing Reg SHO, Reg SHO succeeded in substantially reducing fails to deliver without disruption to the market.⁹

To comply with Reg SHO, Market participants made significant investments in technology to build their operating systems. Sell-side firms invested in technology to automate the process of inventorying, compiling and sending lists of securities available to borrow throughout the day and sending automated confirmations to the borrowing market participant and clearing broker once it located a security. Buy-side firms invested in technology to receive automated lists from the sell-side, to systematically compare the list of securities available to borrow with the firm’s short interest list, to identify hard-to-borrow securities and to automate their process to locate securities to borrow.¹⁰ For an easy-to-borrow security, many buy-side firms employ an automated trading system that electronically locates and places trade orders. For a hard-to-borrow security, the general practice was for a buy-side firm to manually confirm a locate of the security before placing the trade order to minimize the likelihood of a failure to deliver the security. Many prime brokers built in the added step of performing daily reconciliations, identifying short sales that they process with respect to whether a locate was performed in advance of the trade. Such practices instilled discipline into the trading process and reaffirmed the locate process.

We believe great value is derived from the daily publication of a threshold securities list and that it enhances the transparency of the clearing and settlement process. The Reg SHO requirement that self-regulatory organizations publish daily a list of threshold securities informs market participants of securities experiencing persistent fails to deliver and enables them to take extra steps in ascertaining the confirmation of a locate to prevent a failure to deliver securities. The threshold security close-out provision provided market participants with time for a security to clear and settle on its own, or for a market participant to cover its short position. The additional time afforded in Reg SHO prior to a mandatory close-out prevented market disruptions and short squeezes.

⁹ 2006 Regulation SHO Proposed Amendments.

¹⁰ Many buy-side firms have made considerable investments in their systems to automate the locate process. By automating the locate process, firms are effectively able to contact various lenders to confirm the availability of securities to settle trades. This has enhanced competition and lowered the cost of borrowing.

Reg SHO also created operational efficiencies that contributed to tighter bid-ask spreads and more liquid markets. Since Reg SHO became effective in January of 2005, the Commission has adopted several amendments or other enhancements to further reduce fails, including repealing the grandfather provision on August 7, 2007, repealing the options market maker exception on October 14, 2008, and adopting a naked short selling antifraud rule on October 14, 2008.¹¹ The Commission states in the Release that it is concerned that Reg SHO's current provisions "have not gone far enough in reducing fails to deliver" and that "more is needed to reduce fails to deliver." We agree with the Commission that more should be done to reduce the level of fails to deliver. However, given the significant recent amendments and the benefits of the original Reg SHO framework, we believe the Commission should allow some time to consider the effects of the above amendments, as well as consider further amendments to the current Reg SHO framework before abandoning the current framework altogether.

The Commission states in the Release its concern that the close-out provision in Reg SHO only applies to threshold securities. The Release also notes that the vast majority of fails to deliver are closed out within five days after settlement date and that more than 70% of all fail to deliver positions are closed out within two settlement days after settlement date. For short sales, just as the Commission acknowledges for long sales, "fails to deliver may occur . . . within the first two settlement days after settlement date for legitimate reasons" such as "human or mechanical errors."¹² In balancing the interests of market efficiency, market liquidity, timely delivery and settlement, the Commission should conduct an analysis of the U.S. clearance and settlement systems. Such analysis should include data from U.S. securities depositaries, custodian banks, prime brokers and executing brokers in determining the number of days required after settlement date for clearing participants to settle most trades without market disruption.

At a minimum, MFA recommends the SEC require market participants to close-out fails to deliver for all securities at the end of trading on the third day after settlement date. This would allow enough time for the majority of trades to clear on their own without disrupting the efficient functioning of the Continuous Net Settlement system operated by the National Securities Clearing Corporation ("NSCC") and the operations of clearing brokers. Requiring securities that fail to deliver to be closed out at the end of the third day after settlement date would also provide buy-side firms with some time to cover positions and limit the likelihood of a short squeeze. Further, we believe such a rule would better separate trades with legitimate settlement delays from naked short sales. (For a more detailed discussion on market efficiency and liquidity, please see section B.)

Accordingly, MFA recommends the Commission amend Reg SHO by requiring that a participant of a clearing agency take action to close-out a security that has failed to deliver and remained open for six consecutive settlement days by purchasing securities of like kind and quantity at the end of the third consecutive day following settlement date.

¹¹ 2007 Regulation SHO Final Amendments; "Naked" Short Selling Antifraud Rule, Exchange Act Release No. 58774 (Oct. 14, 2008), 73 FR 61666 (Oct. 17, 2008) ("Naked Short Selling Antifraud Rule"); Amendments to Regulation SHO, Exchange Act Release No. 58775 (Oct. 14, 2008), 73 FR 61690 (Oct. 17, 2008).

¹² Release at 61713.

B. Rule 204T

The Commission has instituted Rule 204T in an effort to address disruption in the functioning of the securities markets. We are concerned that Rule 204T unnecessarily constrains legitimate short selling and impairs market liquidity and capital-raising. While we urge the Commission to consider a “reformed” Reg SHO framework once the temporary rule expires, as discussed above, we also request that the Commission consider amending Rule 204T in the interim to allow for more time for securities sold short to settle before the mandatory close-out.

MFA has a few concerns with Rule 204T in its current form. First, we are concerned that Rule 204T has the effect of creating market distortions and erratic market behavior. The requirement that a clearing agency participant with a fail to deliver position immediately close out the fail to deliver “by no later than the beginning of regular trading hours” forces participants to flood the open with orders to purchase. Such action creates artificial buying pressure, which may distort the price of the security and cause sudden fluctuations in borrowing costs. Consequentially, the market impact may harm investors through short squeezes and higher costs.

Second, we are concerned that Rule 204T significantly increases borrowing costs to a degree that negatively affects legitimate short selling, and decreases market liquidity and market efficiency, in a manner similar to the effects of the Commission’s July 15th emergency order which mandated pre-borrowing for shorting select financial company securities (“G19”) (the “Pre-borrow Emergency Order”).¹³ The Pre-borrow Emergency Order was in place from July 21st through August 4th. An economic analysis of the impact of the Pre-borrow Emergency Order, the “July 15th EO Study,” shows that the Pre-borrow Emergency Order:

- Decreased liquidity;
- Increased bid-ask spreads;
- Deteriorated market quality; and
- Decreased market efficiency.¹⁴

As a result, it became much more difficult for investors to trade without having a severe market impact, and prices became less transparent.¹⁵

We are concerned that the borrow requirements of Rule 204T(b), requiring a borrow or an arrangement to borrow securities prior to accepting or effecting further short sales in a security that failed to deliver and has not been closed out, are overly restrictive like the Pre-borrow Emergency Order. Similarly, we believe Rule 204T negatively impacts liquidity, market quality and market efficiency.¹⁶ As originally adopted, Reg SHO’s rule 203(b)(3) more appropriately

¹³See SEC Order Halting Short Selling.

¹⁴ July 15th EO Study, Arturo Bris.

¹⁵ Cf. SEC Order Halting Short Selling *and* Shorting Financial Stocks Should Resume, Arturo Bris, THE WALL STREET JOURNAL, Sept. 29, 2008. As a result of the Short Sale Ban, market liquidity deteriorated, bid-ask spreads increased, and market quality and efficiency deteriorated.

¹⁶ We understand that the Securities Industry and Financial Markets Association will submit comments to the Commission on Rule 204T and provide data showing that Rule 204T causes price spikes, decreases liquidity and increases volatility.

reserves the conservative borrowing requirement for securities with persistent settlement problems only. The requirement of Rule 204T(b) burdens the rest of the market through overly restrictive borrowing practices even when a security fails to deliver as a result of a mechanical or technical error. Furthermore, the costs incurred by broker-dealers are passed on to investors, including the cost of closing out a position even if the settlement delay was due to legitimate reasons.

As the Commission's analysis shows, more than 70% of all fail to deliver positions are closed out within two settlement days after settlement date.¹⁷ We believe even allowing an additional day before requiring a mandatory close-out of a short position that fails to deliver would provide greater regulatory efficiency, allowing more trades to settle and avoiding the need for, and costs of, a mandatory close-out. This would also avoid unnecessary and costly mandatory close-outs for short positions that have been covered prior to settlement date. For example, a short position that is executed on trade date (T) but covered on the day after trade date (T+2) will normally settle on the second day after settlement date for the original trade (T+5). However, due to the hard close-out requirement of Rule 204T, the original short position has to be covered on T+4 despite the fact that the position was already closed out on T+2 and expected to settle on T+5. We note that Rule 204T(e) provides a pre-fail credit, however, the pre-fail credit is tied to a broker-dealer's entire position at NSCC and not to an individual trade. Allowing an additional day after settlement date before requiring a mandatory close-out would create less interference with the efficient functioning of the Continuous Net Settlement process and the operations of clearing brokers, as well as reduce market costs and the likelihood of market distortions and short squeezes.

Accordingly, we recommend the Commission amend temporary Rule 204T by requiring a participant of a registered clearing agency with a fail to deliver position at a registered clearing agency in any equity security close out the fail to deliver position at the end of the third consecutive settlement day following settlement date. If the Commission determines it necessary that short positions that fail to deliver are closed out the following day after settlement date, we urge the Commission to allow market participants until the close of business on the New York Stock Exchange on the following day after settlement date to close-out the positions in order to minimize market impact and price distortions. We also request that the Commission provide an exception for short positions that are covered prior to settlement date and allow an additional two days for such trades to settle.

C. Other Comments

1. Debt securities. The Commission requested comment on whether Rule 204T should be extended to apply to debt securities. Debt securities generally are not the subject of potentially fraudulent short selling activity, and accordingly are outside the scope of Reg SHO, which applies only to equity securities and securities convertible into equity securities. The exclusion of debt securities from Reg SHO clearly illustrates that concerns of manipulative short selling activity are not applicable to debt securities. We are also not aware of a problem or concerns with naked short selling or failures to deliver with respect to debt securities. We believe the Commission should continue to exclude debt securities from Rule 204T.

2. Closing out long sales. The Commission requested comment on whether participants should be able to close out a fail to deliver position for long sale transactions by borrowing as

¹⁷ Release at 61713.

well as purchasing securities. We believe the Commission should allow long sale transactions to be closed out by either borrowing or purchasing securities. In the event a security fails to deliver, borrowing the security or purchasing the security would both serve the same objective of closing out the position. In this context, we believe it is preferable to provide market participants with multiple options. Thus, we believe a participant should be able to close out a fail to deliver position by borrowing or purchasing securities of like kind and quantity.

3. *Arrangement to borrow.* The Commission requested comment on whether it should define “arrangement to borrow.” We do not believe it is necessary for the Commission to define the term. We believe the close out requirement under Rule 204T together with the recently adopted Naked Short Selling Antifraud Rule¹⁸ add additional measures to reduce the number of fails to deliver and address the Commission’s concern for naked short selling. Defining an “arrangement to borrow” as requiring a pre-borrow as evidenced by a contract between the broker-dealer and the lending source would make settling short sales much more restrictive, increase borrowing costs, and reduce liquidity. As evidenced by the July 15th EO Study, overly rigid pre-borrow rules have a negative effect on market liquidity, bid-ask spreads, market quality and market efficiency. We believe that our economy and financial markets would benefit from greater liquidity at this time, and thus, believe that it is not necessary for the Commission to define an “arrangement to borrow.”

4. *Locate requirement.* The Commission requested comment on whether the “locate” requirement is still necessary due to the hard delivery requirement of Rule 204T. We believe it is essential to maintain the locate requirement from Reg SHO. The locate requirement instills good trading discipline among market participants and decreases the likelihood that securities will fail to deliver and that participants will need to pre-borrow securities. In addition, as discussed earlier, many buy-side investors have made significant technical investments in building operations and systems which perform automated locates. By conducting locates buy-side investors are able to reduce costs and search for hard-to-borrow securities. The locate requirement has created a market for securities lending and enabled investors to search beyond their prime broker for borrowing securities. Competition benefits investors through lower prices. As such, we urge the Commission to maintain the locate requirement.

III. CONCLUSION

MFA thanks the Commission for the opportunity to provide comments on Rule 204T and sincerely appreciates the efforts of the staff in navigating through such difficult economic times. We urge the Commission to amend Rule 204T by requiring market participants to close out securities that fail to deliver by the end of the third consecutive settlement day after trade date to avoid creating market distortions and short squeezes which are harmful to investors. We also urge the Commission to consider reforming Reg SHO as discussed herein at the expiration of Rule 204T to maximize investor protection and market efficiency.

(Continued on next page)

¹⁸ See Naked Short Selling Antifraud Rule.

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We would be pleased to meet with the Commission or its staff to further discuss our comments. If the staff has questions or comments, please do not hesitate to call Jennifer Han or the undersigned at (202) 367-1140.

Respectfully submitted,



Stuart J. Kaswell
Executive Vice President & General Counsel

CC: The Hon. Christopher Cox, Chairman
The Hon. Kathleen L. Casey, Commissioner
The Hon. Elisse B. Walter, Commissioner
The Hon. Luis A. Aguilar, Commissioner
The Hon. Troy A. Paredes, Commissioner
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