



## Alternative Investment Management Association

By email only to: [rule-comments@sec.gov](mailto:rule-comments@sec.gov)

19 June 2009

Dear Sirs

### AIMA's comments on the new short sale rules proposed by the Securities and Exchange Commission

AIMA<sup>1</sup> is pleased to have the opportunity to provide comments on the amendments proposed to Regulation SHO, in Release No. 34-59748; File No. S7-08-09 (the Release) by the Securities and Exchange Commission (the Commission).

#### A. AIMA's opposition to price tests

AIMA believes that transparency, rather than price restrictions, should be the goal of any global regulatory regime for short selling and therefore, strongly opposes the introduction of the proposed price test rules. There is some concern among AIMA members that price restrictions are easily subject to 'gaming' - for example, encouraging market participants to re-characterise short positions as long sales in order to avoid the restrictions. Such practices serve to undermine market transparency, with the result that regulators and market participants are unable to gain accurate information on the nature and extent of short positions. Furthermore, given the anticipated adverse impact of such restrictions upon efficient price discovery, we believe that regulation of the settlement of short sales is a better approach to market discipline.

We note that during its Roundtable of 5 May, the Commission acknowledged the absence of empirical evidence establishing the efficacy of price test restrictions for counteracting rapid market declines and the potential adverse market impact arising out of the adoption of a short sale price test, which 'may lead to a decrease in market efficiency and price discovery, less protection against upward stock price manipulation, a less efficient allocation of capital, an increase in trading costs, and a decrease in liquidity.' High frequency traders for example, who are likely to be particularly impacted by the proposed price tests, may withdraw

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<sup>1</sup> AIMA was established in 1990 and is the only professional trade association representing the hedge fund industry with worldwide membership. It is also the only such association which represents all constituencies within the alternative investment management industry - whether hedge fund managers, fund of hedge funds managers, managers of futures or currency funds or those providing other specific services such as prime brokerage, administration, legal or accounting, auditing and tax advisory services. AIMA is a not-for-profit educational and research body. Its membership is corporate and comprises over 1,100 firms in over 40 countries.

The four 'pillars' of AIMA are: Policy, Education, Regulation and Sound Practices. AIMA's objectives are specifically: to provide an interactive and professional forum for our membership and act as a catalyst for the industry's future development; to be the pre-eminent voice of the industry to the wider financial community, institutional investors, the media, regulators, governments and other policy makers; and to offer a centralised source of information on the industry's activities and influence, and to secure its place in the investment management community.



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liquidity from the market in response. In addition, the proposed circuit breaker rules could cause short selling to increase as a stock's price decline approached the 10% trigger level, thereby increasing volatility.<sup>2</sup>

AIMA views the above-mentioned market impact concerns as a strong disincentive with respect to the adoption of any price test rule. We further note that there is empirical evidence from markets around the world that short selling substantially contributes to market liquidity and that restrictions upon short selling impede liquidity and price discovery. For instance, a study of the impact of restrictions on short selling on the London Stock Exchange during the fourth quarter of 2008 found that during the time period that the restrictions were in place, there was an overall decline in liquidity and a widening of bid-asked spreads.<sup>3</sup>

As the Commission acknowledges, its key motivation behind the Release has been the 'deterioration in investor confidence' arising out of extreme market conditions. However, our concern in maintaining investor confidence is, in fact, one of the reasons we oppose the Commission's proposals. We believe that short selling restrictions of this kind weaken and erode benefits including liquidity, price discovery and the ability to manage risk, which will, over time, weaken and erode investor confidence itself.

### B. AIMA's proposals for global reporting regime

AIMA has an over-arching commitment to transparency and the disclosure of systemically important information by large hedge fund managers to their national regulators; this commitment was highlighted in our new policy platform of 24 February 2009<sup>4</sup> and has since been reflected in our work in various areas, including short selling. While the Commission's proposals do not concern disclosure requirements for short selling, AIMA believes that it would be desirable to establish a more consistent international approach to the regulation of short selling by means of disclosure. We are at the forefront of efforts to achieve a global reporting regime for short selling, which would provide regulators with the appropriate information they may need, while giving industry a consistent set of rules with which to comply across all significant markets.

A key component of AIMA's proposals for a global reporting regime is that any information provided to the market on short positions should be provided on an aggregated basis. Neither AIMA nor its members would argue against private disclosure of positions to the regulator. However, we vigorously oppose public disclosure of individual positions to the market and feel strongly that any public disclosure made should be of aggregated data regarding an individual stock. We note that this has worked for some time in the US and other jurisdictions. The objective of a short selling disclosure regime should be to allow a regulator to monitor systemic risk and detect abusive behaviour, which, together with benefits including enhanced market transparency, is achieved via aggregated disclosure.

If a uniform short selling regime is to be agreed - as we would prefer - we would hope that some (at least) of the costs of introducing new systems would be offset by savings arising from a harmonisation of the data required to be provided to different regulatory authorities.

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<sup>2</sup> Concerns raised by market participant panelists at the Commission's 'Roundtable to Examine Short Sale Price Test and Circuit Breaker Restrictions' on 5 May 2009.

<sup>3</sup> '[The Effect of Short-selling Restrictions on Liquidity: Evidence from the London Stock Exchange](#),' Matthew Clifton and Mark Snape (19 December 2008).

<sup>4</sup> AIMA's Press Release 'AIMA Announces New Policy Platform' (24 February 2009) can be found [here](#).



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C. If regulatory action is inevitable, the proposed 'circuit breaker modified uptick rule' would be preferable to the other proposed price tests

One of the alternatives proposed by the Commission is a 'circuit breaker modified uptick rule.' Generally, under this rule, a 10% or more decrease in the price of a covered security from the previous day's last reported trade would require adherence to the modified uptick rule (limiting short sales to a price above the current bid in a declining market and at or above the current bid in a rising market) with respect to that security for the remainder of the trading day.<sup>5</sup>

As discussed, AIMA opposes the institution of any price test or circuit breaker rule and advocates an internationally consistent regulatory approach to short selling with a focus on increased transparency efforts as per its global reporting regime template. However, if regulatory action is inevitable, we believe this proposed circuit breaker rule represents the least objectionable alternative for the following reasons:

- a) Relevant scope: One of the key considerations underlying AIMA's opposition to price tests of any type is their anticipated adverse impact upon liquidity and price discovery. A circuit breaker rule that is limited in application to the stocks that experience a significant one-day price decline would potentially impact liquidity and price discovery in only those stocks, as opposed to the market as a whole.
- b) Short duration: Once triggered, the modified uptick rule would apply only for the remainder of the trading day, which would further minimise its potential adverse impact.
- c) Focused on Current Bid: A circuit breaker rule that triggers a price test focused upon the current bid is preferable to one that triggers a test focused upon the last sale. Given the speed of execution in today's trading markets and the fact that last sale reports are usually not sequential, it is extremely difficult if not impossible to determine what truly was the 'last sale.'
- d) Policies and Procedures Approach: A circuit breaker rule that incorporates a requirement to have reasonably designed policies and procedures for implementation of a price test is preferable to one that incorporates a prohibition against trades in violation of the price test because it provides flexibility to address inadvertent or unpreventable violations. Such flexibility is likely to result in fewer cancellations and trade breaks.

If a circuit breaker modified uptick rule is adopted, AIMA believes that an implementation period of at least 12 months would be appropriate in order to allow for the development and testing of the systems and controls that are necessary to accommodate and enforce the new requirements.

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<sup>5</sup> The proposed rule would except 10% or greater declines during the last 30 minutes of the trading day and would incorporate many of the exemptions in former SEC Rule 10a-1.



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### D. Need for broad-based exemptions to any price test adopted

As stated above, we oppose the institution of any price test or circuit breaker rule. However, in the event that regulatory action is inevitable, we would prefer the circuit breaker modified uptick rule. We would also urge the Commission to reassess the need for broad-based exemptions to any price test adopted.

In the Release, the Commission identifies certain exemptions that are designed to permit the short sale activities that foster liquidity while limiting the potential for manipulation and other concerns underpinning the price test rules. These exemptions would allow a broker to mark a sale as 'short exempt' thereby allowing execution of the transaction without regard to any price test by a trading center<sup>6</sup>. The proposed exemptions largely follow those contained in former Rule 10a-1 and include a few for which the Commission has previously granted additional exemptive relief. Notably absent are exemptions for bona fide market making activities and the exemption previously granted to certain delta-one products including exchange traded funds (ETFs) and exchange traded notes (ETNs).

It is worth noting that, in the Release, the Commission acknowledges that the reasons for previously granting exemptive relief under the former Rule 10a-1 have not changed and further indicates that its 'stated goals' for proposing the short sale price test restrictions would not be undermined by including exemptions which 'parallel' those previously provided.<sup>7</sup> We request that the Commission consider including all of the previously granted exemptions under the former Rule 10a-1, and reconsider the scope of the proposed exemptions in light of the current market that has evolved since the removal of the former price tests.

### Bona Fide Arbitrage and Hedging Activities

While the Commission acknowledges the need for *bona fide* domestic and international arbitrage exemptions that provide market efficiencies, the scope of the proposals is narrowly focused on simplistic forms of price arbitrage and does not envisage the more complex forms of *bona fide* arbitrage transactions engaged in by market participants today. In particular, we believe that the scope of the proposed domestic and international arbitrage exemptions must be broadened to include:

- (a) those *bona fide* strategies and risk management that, while minimising the potential for manipulation, provide necessary market liquidity and efficiency; and
- (b) other forms of convertible securities that differ from standard American-style convertibles.

AIMA considers that both the domestic and international arbitrage exemptions as set forth in the Release are too narrow in scope. For example, many market participants engage in high frequency, complex transactions

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<sup>6</sup> Defined in the Release as 'a national securities exchange or national securities association that operates an SRO trading facility, an alternative trading system, an exchange market maker, an OTC market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent.'

<sup>7</sup> See the Release at p45, 'We are not aware of any reason that the rationales underlying these exceptions and exemptions from former Rule 10a-1 would still not hold true today. Moreover, due to the limited scope of these exceptions and exemptions to former Rule 10a-1, we do not believe that including provisions that would parallel these exceptions and exemptions to former Rule 10a-1 would undermine the Commission's stated goals for proposing short sale price test restrictions.'



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determined by quantitative models that often include taking a corresponding or offsetting position in the same or a comparable security or derivative. These quantitative traders, while pursuing a variety of strategies that often involve hundreds of offsetting orders per second, provide a significant amount of liquidity to the market. We believe that due to the limited scope of the domestic and international arbitrage exemptions, the trading activities of these investors would not be covered as many of the offsetting positions are often taken in swaps, derivatives or in non-standard, non-American style convertibles.

Delta hedging is another legitimate activity that would be adversely impacted by the limited scope of these exemptions. A delta hedge is a dynamic hedging strategy used to limit volatility and whereby an investor purchases a security (a convertible bond) and sells the underlying security short. The investor will seek to maintain the efficacy of the hedge by adjusting the positions, engaging in subsequent purchases or further (short) sales of the underlying security as the underlying security's price fluctuates. Delta hedges rarely, if ever, involve short sales of the equivalent number of securities to which the investor is entitled upon conversion. Rather, the amount of underlying securities sold is dictated by the investor's internal risk management systems.

We strongly urge the Commission to consider broadening the scope of the domestic and international arbitrage exemptions to include those forms of *bona fide* arbitrage and hedging activities that promote market efficiency while limiting the impact of any potential manipulation driving the price of the securities downward. We believe that a failure to broaden the scope would dislocate a significant portion of liquidity provided to the markets by such strategies.

### Exemptions for Exchange Traded Funds (ETFs) and Exchange Traded Notes (ETNs)

The Commission routinely granted exemptive relief from the former Rule 10a-1, for short sales involving the shares of ETFs and ETNs and acknowledged that the rule did not apply to other forms of delta-one products, as the market prices for such products' shares are not susceptible to being manipulated downward by unrestricted short selling. The market prices of these products' shares tends to rise and fall based on the fluctuation in market value of an index and in the underlying index components. Investors determined to manipulate the price of the shares downward would quickly find this to be economically futile as the intrinsic arbitrage opportunity in these products would correct any disparity between the market price of the ETF or ETN shares and the underlying components.

Since the Commission previously granted exemptive relief on this basis and acknowledged that the reasons for granting such relief have not changed, we consider that implementing these prior exemptions would not undermine the Commission's stated goals in proposing a new price test.

### Market Making Exemption

AIMA believes that market makers should be exempt from short selling regulation to the extent that they are acting *bona fide* in that capacity. In order to minimise the administrative burden of coping with two separate regimes, AIMA believes that the exemptions that are part of any price test rule adopted by the Commission should mirror as closely as possible any long position market maker exemptions. We believe that a carefully considered market making exemption would not undermine the goals of the proposed restrictions while allowing market makers to provide necessary liquidity to the market.



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### E. Conclusion

We recognise the pressure faced by the Commission, given the great deal of focus and controversy around short selling, but we strongly oppose the introduction of any price test rules, as we believe that they are not only unwarranted but likely to have an adverse impact on capital markets. We would strongly urge the Commission to move to an aggregated disclosure model which, we believe, is the only viable global model. If regulatory action is inevitable, we believe that the least objectionable rule would be the 'circuit breaker modified uptick rule'. If this rule were to be adopted, we would urge the Commission to consider its implementation in a measured fashion and to re-examine those exemptions previously granted under the uptick rule and bid tests. We also believe that the Commission should reconsider including exemptions for bona fide market making activities and for certain delta-one products; provided that these exemptions are carefully considered to dissuade any manipulation, while providing necessary liquidity to the markets.

If there are any aspects of AIMA's comments which you would like to discuss in greater detail, please do not hesitate to let me know.

Yours sincerely

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