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June 19, 2009

Via Email: rule-comments@sec.gov

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

Re: ***Amendments to Regulation SHO*****, Release No. 34-59748; File No. S7-08-09 (Apr. 10, 2009)**

Dear Ms. Murphy:

Pershing Square Capital Management, L.P. welcomes the opportunity to comment on the amendments to Regulation SHO under the Securities Exchange Act of 1934 (the "Exchange Act") proposed by the Securities and Exchange Commission (the "Commission" or "SEC") in the above reference release (the "Proposing Release").[1]

We recognize and appreciate that the SEC's decision to propose amendments to Regulation SHO to reinstate some form of price test for short sales was prompted by the extreme market conditions experienced in 2008 and as a response to Congressional, corporate and public investor demands to reinstate an uptick rule or even ban short selling. Given the din of complaints from many corners, we commend the Commission and its staff for the effort to guide the amendment process to a reasoned and appropriate outcome.

Under a prior Administration, former SEC Chairman Christopher Cox acknowledged that the Commission's hasty order of a ban on short selling in the securities of certain financial companies in 2008 may have caused more harm than good.[2] More recently, Congress has determined that an eighteen month bi-partisan study is

1 Exchange Act Release No. 59748 (Apr. 10, 2009).

2 *See* Paley and Hilzenrath, SEC *Chief Defends his Restraint*, Page A01, Wash. Post, Dec. 24, 2008 at A1.

required to fully understand the causes of the recent financial decline. [3] Pending the completion of that study, interim actions should be taken with caution.

In reviewing the nearly 3,500 letters commenting on the Proposing Release, and deciding the proper course to take, we urge the Commission to resist making a decision based on the number of comments received. The weight of paper on any side of an issue is a poor substitute for thoughtful judgment on the merits. In coming to its conclusions, we urge the Commission to consider whether the end result is not only "necessary or appropriate in the public interest" and "for the protection of investors", but also whether the adopted rule "will promote efficiency, competition, and capital formation."[4] We believe that these statutorily prescribed considerations should weigh heavily in determining regulation of this issue.

Despite suggestions to the contrary, short selling has neither been the catalyst nor the cause of the massive declines in the capital markets over the last eighteen months. Stories of so-called "bear raids" make for colorful imagery and compelling narratives. They do not, however, provide sound explanations for the causes of damage to the U.S. and global markets.

Following the massive market declines and destruction of great wealth over the very recent past, there is an easy temptation to place the blame for losses on seemingly mysterious market forces. To those who now seek explanations for recent events, we would recommend critical analysis and reflection as a more appropriate response.

Proponents of the view that short selling was the proximate cause of dramatic decreases in equity market valuations typically point to the coincidental 2007 repeal of the uptick rule and ignore (1) the disutility of the credit rating process, (2) the overleveraging of systemically important financial institutions, (3) the sale by some institutions of vast amounts of credit default protection without regard to risk or their ability to make payments when due, (4) compensation policies that created large incentives to take on high levels of risk, (5) the opacity of accounting conventions that shroud losses and obscure accurate measurements of assets and liabilities, and (6) the resulting asset and credit bubble that pre-dated the repeal of the uptick rule. Short sellers have done much to bring light to otherwise dark corners of the capital markets, including raising all of these substantive issues. In so doing, the ensuing transparency has been a force of good in protecting the public interest and investors, as well as promoting efficiency, competition, and capital formation.

We believe, therefore, that new rules and disclosure requirements that have the purpose or effect of inhibiting the market-beneficial impact of short selling should be examined with care and adopted with caution.

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[3] *Fraud Enforcement and Recovery Act*, Pub. L. No. 111-21 (2009).
[4] 15 U.S.C. 78c(f).

I. SHORT SELLING PROMOTES EFFICIENCY, COMPETITION AND ACCURATE PRICE DISCOVERY

The Commission, of course, is well aware of the benefits of short selling and noted in its release proposing the rescission of Exchange Act Rue 10a-1 that:

> [s]hort selling provides the market with at least two important benefits: market liquidity and pricing efficiency. Market liquidity may be provided through short selling by market professionals, such as market makers (including specialists) and block positioners, to offset temporary imbalances in the buying and selling interest for securities. These short sales make stock available to purchasers and reduce the risk that the price paid by purchasers is artificially high because of a temporary contraction of selling interest. Short sellers covering their sales also may add to the buying interest of stock available to sellers.
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> In addition, short selling contributes to the pricing efficiency of the equities markets. Efficient markets require that prices fully reflect all buy and sell interest. Short sales reflect the view that the security is overvalued and the price of the security will fall, just as long purchases reflect the view that the security is undervalued and the price will rise. Both the long purchaser and the short seller hope to profit, or hedge against loss, by buying low and selling high, though the strategies differ in the sequence of transactions. Market participants who believe a stock is overvalued may engage in short sales in an attempt to profit from a perceived divergence of prices from true economic values. Such short sellers add to stock pricing efficiency because their transactions inform the market of their evaluation of future stock price performance. This evaluation is reflected in the resulting market price of the security.[5]

Academics and market analysts have further noted the benefits of short selling, including that short selling reduces the average time in which corporate misconduct is brought to light (*i.e.*, from 26 to 18 months), dampens share price inflation for a company that is engaging in financial fraud, buffers share price declines following public disclosure of corporate misdeeds, and signals those companies that will be discovered to have misrepresented their finances.[6] Short selling has also been found to increase

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[5] *Amendments to Regulation SHO and Rule 10a-1*, 71 FR 75068, 75069-75070 (Dec. 13, 2006) citing Owen A Lamont and Richard H Thaler, *Can the Market Add and Subtract? Mispricing in Tech Stocks Carve-outs*, J. Political Economy, May 2001.

[6] *See, e.g.,* Karpoff, Jonathan M. and Lou, Xiaoxia, *Do Short Sellers Detect Overpriced Firms? Evidence from SEC Enforcement Actions* (Sept. 6, 2008). AFA 2008 San Francisco Meetings Paper; EFA 2008 Athens Meetings Paper. (available at http://ssrn.com/abstract=1102853). (The authors based their findings on a review of more than 600 cases of corporate fraud.). *See also* Desai, Hemang, Krishnamurthy, Srinivasan and Venkataraman, Kumar, *Do Short Sellers Target Firms with Poor Earnings Quality?*

liquidity and improve market quality by narrowing spreads and fostering orderly buy and sell transactions.[7]

If the price discovery mechanism and informational benefits of short selling are abandoned or sufficiently impeded, public investors, including those who now call for the imposition of new and onerous uptick rules or adoption of other material restrictions on short selling, risk harm. If short selling is impeded, not only will individual investors have less, and less accurate, information available to them about the prices at which securities should trade and the value of companies in which they invest, but the asset managers and allocators of capital who invest as fiduciaries on their behalf will have fewer and less accurate data points to make decisions about asset allocation and the value and risks of particular investments.

The benefits of accurate pricing of assets and risks, provided in part by short sellers, are immeasurable and profound. This is particularly the case when individual capital allocation decisions are aggregated across an economy and understood as a reflection of how our society, as a whole, sets its priorities.

II. RULES SHOULD BE TAILORED TO ADDRESS THE PROBLEM IDENTIFIED

Many of the commentators who seek increased regulation of short sales cite the evils of so-called "naked" short selling, which they believe occurs with abandon. If, in fact, there is an abundance of naked short selling, we believe it should be addressed by the Commission through its aggressive enforcement of its general antifraud proscriptions, and particularly Exchange Act Rule 10b-21, which is directed at short sellers who fail to deliver borrowed shares and who effected their short sale transactions with the intention of failing to deliver borrowed shares.[8]

We believe, however, that perceptions of rampant naked short selling may actually be the fall-out from lax stock loan and locate practices by broker-dealers. For example, the SEC's Office of Economic Analysis ("OEA") studied the effect of the Commission's adoption of interim final temporary Rule 204T of Regulation SHO[9] as well as the elimination of the options market maker exception in Rule 203 of Regulation SHO, and concluded that these contemporaneous rule amendments reduced the number of fails to deliver by 47.2% across all securities.[10]

Evidence from Earnings Restatements (Dec. 2004) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=633283).

7 *See generally* Matthew Clifton and Mark Snape, *The Effect of Short-selling Restrictions on Liquidity: Evidence from the London Stock Exchange* (Dec. 19, 2008) (available at: http://www.londonstockexchange.com/NR/rdonlyres/5EDD66EF-B589-4974-95B1-73C51F1C9DFC/0/ShortsellingRestrictionsandMarketQualityDecember2008.pdf).

8 17 CFR § 240.10b-21(a).

9 *See Amendments to Regulation SHO*, Exchange Act Release No. 58773 (Oct. 14, 2008).

10 *See OEA. Impact of Recent SHO Rule Changes on Fails to Deliver* (Mar. 20, 2009).

We suspect that, before the Commission tightened the time period for closing out fail to deliver positions, broker-dealers were more haphazard in how they provided locate services to buy-side customers. Buy-side customers depend on their broker-dealers to keep the broker-dealers' commitments to locate and furnish the shares that are required to be delivered to settle short sale transactions.

Typically, a broker-dealer locates borrowed securities for a customer at or before the time of the customer's order entry (*i.e.*, trade date). This means that the customer has identified the broker as the source of securities that will be delivered on settlement date in order to avoid a naked short sale and to prevent a failure to deliver. If, at the time of settlement of the trade, the shares that were previously located are not available (*e.g.*, if it is hard to borrow the securities that were sold and the source of the previously located shares had subsequently transferred or loaned the shares to another party), a failure to deliver could arise. On the surface, from a market monitoring perspective that failure to deliver would be indistinguishable from a naked short sale – notwithstanding the fact that the customer relied on its broker to identify and deliver borrowed shares at the time of settlement of the short sale.

While stock loan and locate practices arguably have been strengthened since the adoption of Rule 204-T, we believe that Commission and self-regulatory organization guidance regarding appropriate policies and procedures, including the respective obligations of executing brokers and prime brokers, would be helpful in further reducing fails to deliver.

We believe that this will eliminate a substantial portion (if not the bulk) of the short selling-related activity that has the appearance of naked short selling.

III. "THE REMEDY [SHOULD NOT BE] WORSE THAN THE DISEASE"[11]

Some commentators have asked that the Commission impose mandatory pre-borrow (or arrangement to borrow) requirements. As OEA determined from its study of the impact of the pre-borrow requirements in the SEC's July 15, 2008 Emergency Order,[12] the costs of borrowing for short sales in the stocks of the 19 covered issuers (*i.e.*, "stock loan rates") dramatically increased while the Emergency Order was in place.[13] Accordingly, if the SEC were to impose pre-borrow requirements market-wide, we would expect the three-day cost of borrowing to increase for all short sales.

Prior to imposing such a burden on the market, we believe the Commission, as part of a rulemaking process, should identify the policies and goals it seeks to achieve

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[11] Francis Bacon, *Essays Civil and Moral* (Bartleby.com 2001).

[12] *See Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Development*, Exchange Act Release No. 58155 (July 15, 2008).

[13] *See OEA. Analysis of the July Emergency Order Requiring a Pre-Borrow on Short Sales* (Jan. 14, 2009).

and provide a cost-benefit analysis comparing the direct and indirect costs of adopting a mandatory pre-borrow (or arrangement to borrow) requirement for all securities versus any incremental costs to broker-dealers of enhancing their policies and procedures relating to stock loan practices. We urge the Commission to carefully evaluate the potentially significant impact to market liquidity and price discovery of disincentivizing short selling by increasing trading costs through pre-borrow requirements.

IV. TRANSPARENCY

A. The Utility of Form SH Information

In addition to commenting on proposed Rule 201, we wish to make a few comments and observations about Interim Final Temporary Rule 203-T and Form SH.[14] Pershing Square has no objection, on principal, to providing the SEC with short sale and short position information as is currently required by Form SH. The collectively increased regulatory burdens on institutional investment managers from creating and maintaining short-related information, together with the related (and inevitable) SEC staff access to that information, support, in our view, a more efficient presentation of short sale and short position information to the Commission on a periodic basis.

Although the Commission sought public comment on whether Rule 203-T and Form SH should be made permanent requirements or allowed to expire at the end of July 2009, it has not provided any information to the public about the data that it has received from investment managers since reporting was first required in September 2008, or how such data has been used by the Commission and whether it is programmatically useful to the Commission and its staff.[15]

There is no doubt that elements of an early-warning mechanism by way of weekly disclosure to the Commission could provide a policy basis for making Form SH a permanent requirement. However, in order for the public to comment effectively on the requirements of Form SH as they currently exist and as they are proposed to be amended, we believe that the Commission should articulate how it has used the Form SH data over the past nine months, and how continued receipt of such data is necessary or appropriate in the public interest, including for the protection of investors.

If the Commission adopts Form SH on a permanent basis, we have a suggestion that we believe would greatly increase the value of the information provided to the Commission and would allow it to leverage the fundamental economic analysis reflected in professional investment managers' short selling decisions. Specifically, we recommend that the SEC amend Form SH to provide for voluntary reporting by managers

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[14] *See Disclosure of Short Sales and Short Positions by Institutional Investment Managers,* Exchange Act Release No. 58785 (Oct 15, 2008).

[15] See *Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments,* Exchange Act Release No. 58591 (Sept. 18, 2008).

of their reason(s) for their short selling activities and positions by classifying the investment decisions that led them to short any particular equity. By way of example, imagine a Form SH that allowed a portfolio manager to check one or more of the following four boxes to indicate whether a short is:

- ☐ A fundamental short (*e.g.*, reflecting a view that the security's issuer has a flawed business strategy, is overvalued and/or its business prospects are diminishing);

- ☐ A fraud short (*e.g.*, reflecting a suspicion of fraudulent activity, or possible accounting irregularities)

- ☐ A directional short (*e.g.*, reflecting a view about the market, industry, or sector generally, or of a cyclical nature); and/or

- ☐ A market neutral short (*e.g.*, a hedge for a paired trade, portfolio insurance, or the close-out of a long position).

Under this suggested approach, the Commission could aggregate information garnered from market participants' trading activities to better assess short sale information, prioritize investigative staff's efforts, and even identify or anticipate problems before they occur. Given the voluntary nature of such disclosure, its limited dissemination to the Commission only, and the development of an appropriate classification system, we believe that investment managers would support this type of disclosure.

B. Responding to Calls for Broad Public Disclosure of Short Information

Some commenters have advocated for real time public disclosure of information furnished on Form SH because they think it will impede short selling. Imposing such obligations for the purpose of disincentivizing short selling would be inconsistent with the Commission's obligation under the Exchange Act to consider whether rulemaking is necessary or appropriate in the public interest and will promote efficiency, competition, and capital formation. Moreover, real-time public disclosure could have the opposite impact, *i.e.*, it could provide opportunities for lawful "herd" trades where groups of participants identify and act on the same short opportunities by virtue of the prevalence of the public disclosure of those short positions. This could exacerbate rather than ameliorate the perceived harms of short selling.

Furthermore, several commenters have proposed including short positions in the disclosure regime for long positions set forth in Exchange Act Section 13(d)(1). We believe that the legislative history of Section 13(d)(1), which is part of the Williams Act,[16] provides no basis for such action. The legislative history of that section indicates

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[16] Pub. L. No. 90-439, 82 Stat. 454 (1968).

that it was intended to provide information to the public and the affected issuer about rapid accumulations of its voting equity securities by persons who would then have the potential to change or influence control of the issuer.[17] The rationale for Section 13(d)(1) provides no basis for requiring short position disclosure.

Should the Commission consider requiring public disclosure of short position information on a delayed basis, we believe that a new focused proposal should be approved by the Commission and the public should be given notice of the details of such a proposed disclosure requirement as well as both the statutory and investor and market protection bases for requiring disclosure, and have an opportunity to provide informed comments based on such information.

V. CONCLUSION

Pershing Square commends the Commission and its staff for their hard work to address the many difficult issues in this challenging environment. We appreciate the opportunity to submit these comments, and are available to meet and to discuss these matters with the Commission and its staff and to respond to any questions.

PERSHING SQUARE CAPITAL MANAGEMENT, L.P.

Sincerely,

/s/ Roy J. Katzovicz
Chief Legal Officer

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[17] *See* Exchange Act Release No. 17353 (Dec. 4, 1980).