April 26, 2022

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Short Position and Short Activity Reporting by Institutional Investment Managers (File No. S7-08-22, RIN 3235-AM34)

Dear Ms. Countryman:

Better Markets[1] appreciates the opportunity to comment on the above-captioned proposal ("Proposal" or "Release") issued by the Securities and Exchange Commission ("SEC" or "Commission").[2] The Proposal would enhance the disclosure regime for short sales and short activity by requiring institutional investment managers whose short positions meet or exceed the prescribed threshold to report short position and short activity data on a form prescribed by the Commission. The Proposal would also add a new "buy to cover" order-marking requirement and amend the plan for the Consolidated Audit Trail ("CAT") to require 1) reporting of the new "buy to cover" order-marking information, as well as 2) reporting of reliance on the bona fide market-making exception to the Commission's current short sale rules.

INTRODUCTION AND BACKGROUND

Short Sales

As explained by the SEC in the Release, a short sale is the "sale of a security that the seller does not own, or a sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller."[3] Generally speaking, a short seller borrows a security from a lender and then sells it. Eventually, the short seller must repay the lender, and so must purchase the security

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1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

2 87 Fed. Reg. 14,950 (Mar. 16, 2022).

3 Release at 14,951.

and convey it back to the lender. If the price falls during this period, the short seller profits from the trade; if the price rises, the short seller loses money on the trade.[4] Essentially, a short sale is the mirror image of buying a stock—purchasing a stock is typically a bet that the company will do well and its share price will rise, whereas shorting a stock is typically a bet that the company will do poorly and its share price will go down.

Concerns Raised By Short Sales

Most people recognize that "short selling **can** be one component of a well-functioning, liquid securities market and can contribute useful information to the price discovery process, under the right regulatory conditions."[5] However, the nature of short selling means that it raises unique concerns, not only for those engaged in short selling, but also for the SEC, issuers, other investors, and the public. These concerns are less relevant to being long a stock. For example, investors who have purchased a stock can only lose the amount they have actually invested to buy the stock—if you buy $5,000 worth of Acme stock today, and Acme goes bankrupt tomorrow, you can only lose your $5,000 investment, since losses are limited by the fact that the furthest a stock's price can fall is to $0. By contrast, there is no upper limit on how high a stock's price can go. Since short sellers lose money when the price of a stock goes up, and there is no limit to how high the price of a stock can go up, there is, in theory, no limit to a short seller's losses, meaning being short a stock is significantly riskier than being long a stock.[6] That increased riskiness is obviously significant to those who are short the stock, but also significant to the SEC as a financial markets regulator. It means that short positions can entail significantly more systemic risk than equivalent long positions; it also means that traders who are short a stock may have more incentive to attempt to engage in fraud, manipulation, and other market abuses, such as so-called "short-and-distort" schemes to stem potentially unlimited losses.[7]

Short sellers can also destabilize markets by contributing to downward price spirals. As one commentator explained:

> "The most potent of the perceived threats that short selling presents is its ability to destabilize orderly securities markets. Due to their large volume and speed of implementation short sales may create downward price spirals. These may be both the result of other traders' inability to insert buying orders in a rapidly falling market

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[4] Short sales are not always specifically intended to profit from the falling value of a security. As the Release explains, investors may engage in a short sale to hedge the risk of another position, and short sales may be used by market makers or other market professionals "to provide liquidity in response to unanticipated demand." Release at 14,951.

[5] BETTER MARKETS, SHORT SELLING: 10 RECOMMENDATIONS FOR IMPROVING THE SEC'S REGULATORY FRAMEWORK (May 4, 2021), https://bettermarkets.org/analysis/short-selling-10-recommendations-improving-sec-s-regulatory-framework/.

[6] *See* Release at 14,984.

[7] As the Release explains, in a "short-and-distort" scheme, "the goal of manipulators is to first short a stock and then engage in a campaign to spread unverified bad news about the stock with the objective of panicking other investors into selling their stock to drive the price down." Release at 14,992.

> or unwillingness to take a long position, since the market's continuous decline may accrue big losses to such long positions. Furthermore, short selling that causes a significant price fall may also force long traders to liquidate their positions because of funding pressures, e.g., margin calls, feeding further downward price spirals, or in order to avoid losses due to strategic trade behaviour, namely, herding.
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> A free falling share price affects issuer's standing among investors and impairs issuers' ability to raise fresh capital or obtain credit. Also, the precipitous collapse in the market price of a security may have implications for the wider market in terms of investor confidence. Namely, a precipitous collapse in the market price of a stock, due to short selling, may have a contagious effect spreading downward price pressures to the rest of the market and destabilizing market prices in all stocks of the same sector or the market as a whole."[8]

Another relevant aspect of short selling is that, generally speaking, a short sale is a bet against a company's success. If the company struggles, as short sellers bet it will, that will almost certainly mean significant negative consequences for a variety of stakeholders. Most obviously, investors in the company will suffer losses as the company struggles, and in turn, executives may find themselves under fire from those same investors. However, other stakeholders may also suffer if short sellers turn out to be right—a struggling company may have to lay off employees, close locations, and pare back product offerings, which could impact customers, suppliers, and vendors. For these and other reasons, issuers, investors, and the general public tend to view short sellers with a significant degree of skepticism, if not scorn, even where short sellers are engaged in legitimate, non-abusive trading.[9] This skepticism can have a number of negative consequences—among other things, it can cause the public, including investors, to reflexively credit an issuers' pushback that a short seller is incorrect, or lying, about the condition of a company, when it may in fact be the issuer that is incorrect or, worse, engaging in abusive or manipulative tactics.

Current Regulation of Short Sales

Regulation SHO is the primary rule that governs short sales, including disclosure requirements.[10] The distinctive characteristics of short sales would seem to suggest that, if short sales were governed by different reporting requirements than long positions, short sales would have **more robust** requirements. Yet, Regulation SHO prescribes **less robust** transparency requirements for short positions than those applicable to long positions. For example, institutional investment managers' long positions have been subject to reporting requirements since 1979, but

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8 Emilios Avgouleas, *A New Framework for the Global Regulation of Short Sales: Why Prohibition Is Inefficient and Disclosure Insufficient*, 15 Stan. J.L. Bus. & Fin. 376, 403–04 (2010).

9 Reid Stimpson, *Short Sellers: Market Traitors or Balance Keepers*, McGill Bus. Rev. (Nov. 30, 2020), https://mcgillbusinessreview.com/articles/short-sellers-market-traitors-or-balance-keepers.

10 17 C.F.R. §§ 242.200-204.

the SEC has not adopted similar reporting requirements for short positions. This is despite the fact that Congress, in Section 929X of the Dodd-Frank Act, explicitly mandated that the SEC

> "prescribe rules providing for the public disclosure of the name of the issuer and the title, class, CUSIP number, aggregate amount of the number of short sales of each security, and any additional information determined by the Commission following the end of the reporting period. At a minimum, such public disclosure shall occur every month."[11]

As the SEC explains, while Regulation SHO contains some recordkeeping requirements, and while self-regulatory organizations ("SROs") such as the Financial Industry Regulatory Authority ("FINRA") publish some short sale data, because "regulations currently do not require market participants to record, report, or track when short sellers buy-to-cover their short sales," it is difficult for the SEC to determine whether brokers are complying with the requirements of Regulation SHO.[12]

Substantively, Regulation SHO focuses on the mechanics surrounding short selling, not the level of transparency associated with the level or volume of short selling. It requires that brokers appropriately mark sale orders as "long," "short," or "short-exempt."[13] It also requires that brokers actually locate a security to borrow to sell short before accepting a short sale order, but exempts short sales "effected by a market maker in connection with 'bona fide' market making activities" from the locate requirement.[14] Brokers are also required to deliver securities on a long or short transaction to a clearing agency by the settlement date, or otherwise to appropriately close out a failure to deliver by obtaining "securities of like kind and quantity by the applicable close out date," which for a short sale is the beginning of trading hours on the third business day following the trade.[15] Regulation SHO also contains a circuit breaker that becomes effective "when triggered by a price decline of 10% or more from a covered security's prior closing price" and, when effective, restricts the prices at which the covered security may be sold short, "i.e. it must be above the current national best bid."[16] This restriction applies to short sales for the rest of the day and the following day, absent an exception.[17]

Shortcomings in the SEC's Short Sale Reporting Regime

The failure of the SEC to mandate transparency requirements for short positions at least as robust as those applicable to long positions can have bizarre and destabilizing results. As one example, in 2012, a well-known short seller, David Einhorn, asked a "handful" of "fairly

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11 15 U.S.C. § 78m(f)(2).
12 Release at 14,987.
13 Release at 14,987. The "short-exempt" order marking requirement relates to the "short sale price test circuit breaker." *Id.*
14 Release at 14,987.
15 Release at 14,987.
16 Release at 14,987.
17 Release at 14,987.

innocuous" questions at an earnings call for nutritional supplement company Herbalife.[18] Because of these few innocuous questions, Herbalife stock "tumbled," resulting in a loss of "more than $1 billion in stock market value" even though Mr. Einhorn did not disclose whether or not he actually had shorted Herbalife stock—in the absence of disclosure requirements investors simply assumed that his questions were an indication of trouble at the company.[19] Weeks later, at a hedge fund conference, "speculation was rife that Herbalife would be a focus of a presentation by Mr. Einhorn," but when Mr. Einhorn's presentation did not mention Herbalife at all, it "set off a small rally in Herbalife stock as it shot up almost 17 percent, pushing the company up $800 million in value."[20] In other words, over the course of several weeks the stock price of Herbalife fluctuated wildly, not because of any actual direct information about its business prospects, but because investors were forced to speculate about the potential interest of a single trader known to favor short selling. Had that trader's position been subject to a reporting requirement, investors would have had a credible basis for assessing Mr. Einhorn's various statements and non-statements.

But perhaps the most prominent example of the severe market disruptions and other issues that can arise from the lack of transparency around short selling is the frenzy surrounding GameStop and other heavily shorted so-called "meme stocks" in January 2021. Fueled by a general mistrust of Wall Street and a specific mistrust of short sellers, some day traders, led by posters on the "r/wallstreetbets" forum on Reddit, began a campaign to promote buying shares of GameStop, and other stocks that were, in their opinion, being unfairly targeted by hedge funds engaged in what Redditors speculated were abusive and manipulative practices to support their short position.[21] For most of 2020, GameStop, already facing intense competition from online retailers such as Amazon before becoming subject to pandemic-era restrictions, was subject to significant short selling pressure and its price remained below $10. However, its share price started to rise in the Fall as the buying campaign gathered momentum. The price skyrocketed to unprecedented levels in January 2021. On January 12, 2021, it closed at $19.95. By January 27,

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[18] Steven Davidoff Solomon, *Disclosure by Short-Sellers Would Improve Market Clarity*, N.Y. Times DealBook (May 22, 2012), https://dealbook.nytimes.com/2012/05/22/disclosure-by-short-sellers-would-improve-market-clarity/.

[19] *Id.*

[20] *Id.*

[21] *See* Ben Winck, *The GameStop Mania Driven by Reddit Rraders Isn't Simple Market Trolling. It's a Populist Movement Threatening to Disrupt the Financial System to a Degree Occupy Wall Street Only Dreamed Of*, Business Insider (Jan. 30, 2021), https://www.businessinsider.com/gamestop-wallstreetbets-reddit-trader-mania-populist-movement-occupy-wall-street-2021-1; *see also* veryforestgreen, *Short Interest Update on GME for 11/30/20 With Commentary of the Latest Conference Call*, Reddit (Dec. 9, 2020) ("GameStop is like PLTR, manipulated to hell by hedge funds"), https://www.reddit.com/r/wallstreetbets/comments/ka3gey/short_interest_update_on_gme_for_113020_with/, CPTHubbard, *GME Short Squeeze and Ryan Cohen DD for Jim Cramer, The (Man)Child Who Wandered Into the Middle of the GME-Cohen Movie*, Reddit (Dec. 23, 2020) ("So fine, they're [GameStop] doing ok on debt and cash. But who even goes to that 90s-[redacted]-Looking Cluttered Mall Geekery anymore anyways? I confess: in my darkest moments, **as the short sellers manipulate the [redacted] out of this stock** and I curse the names Bell and Sherman, I too have wondered this.") (emphasis added), https://www.reddit.com/r/wallstreetbets/comments/kito44/gme_short_squeeze_and_ryan_cohen_dd_for_jim/.

2021, it closed at an astonishing $347.51, before reaching an intraday high of $483 the next day.[22] This extraordinarily rapid rise in price had the desired effect of punishing the short sellers that Redditors believed were attempting to manipulate the market—one of the most prominent shorts, Melvin Capital, was at one point losing $1 billion a day and ultimately lost $6.8 billion in January 2021 due to the price spike.[23]

However, it was not only short sellers that suffered during the frenzy. As the price became increasingly volatile and skyrocketed, the brokers with large positions in GameStop from their clients' trading activity were required to deposit additional money with clearinghouses to cover the value of those positions and the associated risk of defaults. One of those brokers, Robinhood, through which a large number of shares of GameStop were being traded by retail investors, was unable to meet a $3 billion margin call from its clearinghouse and it halted buying in GameStop and certain other meme stocks.[24] According to lawsuits filed in response to Robinhood's actions, the price drop from its peak in late January was a direct result of the buying halt because it triggered a sell-off that caused the share price of GameStop and other meme stocks to plummet. This left many investors who had bought stock as the price was going up selling into a suddenly declining market, resulting in significant losses for retail investors who had "to choose between selling the [stocks subject to Robinhood's buying halt] at a lower price or holding their rapidly declining positions in the [stocks subject to Robinhood's buying halt]."[25] Indeed, by February 4, 2021, GameStop's stock had slid to $53.50, imposing "heavy losses" on retail investors.[26]

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22 SEC, STAFF REPORT ON EQUITY AND OPTIONS MARKET STRUCTURE CONDITIONS IN EARLY 2021 at 17 (2021), https://www.sec.gov/files/staff-report-equity-options-market-struction-conditions-early-2021.pdf.

23 Juliet Chung, *Hedge Fund Melvin Lost $6.8 Billion in a Month. Winning It Back Is Taking a Lot Longer*, Wall St. J. (Jan. 28, 2022), https://www.wsj.com/articles/melvin-plotkin-gamestop-losses-memestock-11643381321.

24 Alexander Osipovich, *Clearinghouse Urges Faster Trade Settlement Amid GameStop Scrutiny*, WALL ST. J. (Feb. 24, 2021), https://www.wsj.com/articles/clearinghouse-urges-faster-trade-settlement-amid-gamestop-scrutiny-11614175201.

25 Consolidated Class Action Complaint at 5, *In re January 2021 Short Squeeze Trading Litigation*, No. 21-2989-mdl-altonga (S.D. Fla. Jul. 27, 2021). Many suspected something nefarious in the Robinhood trading halt. Specifically, Robinhood sells a significant portion of its order flow to Citadel, a market-maker. In other words, Citadel is one of Robinhood's biggest customers. Citadel also separately operates a hedge fund. In the middle of the market volatility, Citadel's hedge fund made a significant investment in Point72, another hedge fund that was heavily short GameStop stock and that, accordingly, had suffered enormous losses as the price of GameStop rose. Thus, many speculated that Robinhood's buying halt was intended to benefit its customer, Citadel, although no evidence has emerged of this or any other manipulation or other wrongdoing related to the trading halt. *See* Jeff Kearns & Hema Parmar, *Robinhood, Citadel Reject Conspiracy Claims That They Halted 'Meme' Trades*, L.A. TIMES (Feb. 17, 2021), https://www.latimes.com/business/technology/story/2021-02-17/robinhood-citadel-reject-conspiracy-claims-they-halted-meme-trades.

26 *See* Drew Harwell, *As GameStop Stock Crumbles, Newbie Traders Reckon With Heavy Losses*, WASH. POST (Feb. 2, 2021, 5:34 PM), https://www.washingtonpost.com/technology/2021/02/02/gamestop-stock-plunge-losers/.

A report in the Wall Street Journal would later examine the consequences of the SEC's failure to implement short position reporting requirements as mandated by Congress. It revealed, among other things, that "SEC officials have acknowledged in conversations with Wall Street executives that it could have been useful during the most recent tempest to have a repository of data to draw on for a fuller picture."[27] Ultimately, the report explained, the SEC's lack of insight into short sale activity inhibited its ability to respond to the ongoing frenzy as it unfolded:

> "[I]mplementing the rules would have given the SEC more visibility into the exact sizes of positions by big investors. It would have allowed them to know, for instance, if just a few hedge funds accounted for the short interest in GameStop, creating a higher likelihood that the stock would skyrocket if they had to buy back the stock and unwind their positions."[28]

The lack of transparency into short positions did not just hamper the SEC's understanding of the GameStop crisis as it unfolded but may also be interfering with the SEC's and market observers' ability to say with confidence what happened in retrospect. The staff of the SEC conducted a study of the frenzy and produced a report which, among other things, concluded that the price rise GameStop experienced in January 2021 was not the result of a short squeeze or a "gamma" squeeze (although acknowledging that much of the buying interest observed may have been motivated by a "desire to maintain a short squeeze.").[29] However, some prominent academics have taken issue with this aspect of the SEC staff report, arguing that, in fact, the evidence indicates that the GameStop's price increase might have been fueled by both a short squeeze and a gamma squeeze.[30] It is beyond the scope of this comment letter to attempt to determine which view is correct, but that two sets of highly qualified professional market observers could come to such different conclusions about the same short-sale-driven event is indicative of insufficient transparency into short sale activity.

OVERVIEW OF PROPOSAL

The Proposal would require that institutional investment managers report short sale activity if they have either: (1) any gross short position worth $10 million or more during any settlement date during the reporting month; or (2) a monthly average gross short position that represents 2.5%

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27 Dave Michaels & Dawn Lim, *GameStop Frenzy Prompts SEC to Weigh More Short Sale Transparency*, Wall St. J. (Feb. 17, 2021), https://www.wsj.com/articles/gamestop-frenzy-prompts-sec-to-weigh-more-short-sale-transparency-11613593827.

28 *Id.*

29 SEC, STAFF REPORT ON EQUITY AND OPTIONS MARKET STRUCTURE CONDITIONS IN EARLY 2021 at 25-29 (2021), https://www.sec.gov/files/staff-report-equity-options-market-struction-conditions-early-2021.pdf. A gamma squeeze "occurs when market makers purchase a stock to hedge the risk associated with writing call options on that stock, in turn putting further upward pressure on the underlying stock price." *Id.* at 29.

30 A REPORT BY THE AD HOC ACADEMIC COMMITTEE ON EQUITY AND OPTIONS MARKET STRUCTURE CONDITIONS IN EARLY 202 (Jan. 28, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4030179.

or more of shares outstanding in the security.[31] A reporter would be required to identify each position as unhedged, partially hedged, or fully hedged. Such reports would be due within 14 business days of the end of the reporting calendar month. The SEC would publish information on the short interest in each relevant security, aggregated across all institutional investment managers. The SEC also proposes to amend Regulation SHO to require that broker-dealers properly indicate whether an order is a "buy-to-cover" and report such orders to the CAT. Finally, the SEC would require brokers to indicate when they are relying on the "bona fide market making" exception to the locate requirement.[32]

COMMENTS

I. THE REQUIRED REPORTING MUST INCLUDE FUNCTIONALLY EQUIVALENT DERIVATIVES POSITION TO ENSURE THAT THE FINAL RULE ACTUALLY INCREASES TRANSPARENCY INTO SHORT POSITIONS AND SHORT ACTIVITY

The SEC correctly identifies several key benefits it anticipates will result from meaningfully increasing transparency into short positions. Greater transparency

> "would result in improved regulatory oversight, as the data that would become available to regulators would close informational gaps in the currently available data, which would in turn benefit market participants and help foster fair and orderly markets. More specifically, the Proposals would increase transparency and improve regulators' examination of market behavior and recreation of significant market events. These improvements may, in turn, discourage abusive short selling. Proposed Rule 13f-2 would also increase transparency for market participants about short selling, which could help refine market participants' understanding of the level of negative sentiment and the actions of short sellers."[33]

In many ways, the SEC has thoughtfully crafted a Proposal that will achieve these anticipated benefits. Simply requiring more transparency will provide market participants with information about the activities of short sellers, which may in and of itself reduce some of the suspicions that surround short sale activity. As we saw during the GameStop trading frenzy, such suspicion—understandable but not informed with data—helped fuel volatility. Likewise, requiring that institutional investment managers report gross short positions, as opposed to net short positions, in conjunction with the requirement that they report whether a short position is hedged, will provide the SEC and market participants with more information about short positions that are in the market as well as the context of those short positions. The "buy-to-cover" order-marking requirement, in conjunction with required reporting to CAT of buys-to-cover and also of

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[31] Release at 15,015.
[32] Release at 14,950.
[33] Release at 14,981.

reliance on the bonafide market making exception to the locate requirement, should help the Commission monitor short selling activity and actually ensure compliance with Regulation SHO's requirements. Each of these thoughtful aspects of the Proposal is critical to its success and must be retained.

However, in order to successfully achieve these benefits, the SEC must craft a rule that is reasonably expected to capture a meaningful amount of usable data on short positions. If the final rule fails to do that, it will not achieve the promised benefits—short sellers will continue to be viewed with suspicion and the SEC will continue to have trouble spotting violations of its short selling rules, identifying instances of manipulation and dangerous concentrations of short interest, or reconstructing significant market events related to short selling. Unfortunately, the Proposal contains one glaring weakness that, if finalized, would almost certainly undermine the utility of the rule—it would not require that institutional investment managers include derivative positions that are functionally equivalent to a short position to determine whether it meets the reporting thresholds. This flawed approach will almost certainly facilitate evasion of the reporting rules, undermining the Proposal's stated goal of increasing transparency.

The SEC must correct this flaw in the final rule by making clear that derivatives must be included in the calculation of short positions. Otherwise, the rule will not fully and meaningfully increase transparency into short positions. The SEC should also strengthen some aspects of the rule. As it considers these and other improvements that will enhance transparency, the SEC must keep in mind that its primary statutory mandate is to protect investors, the integrity of the markets, and capital formation, all of which will be enhanced by a strong rule that increases transparency. Protecting companies' bottom line, or otherwise helping reduce their compliance costs and complexity of operations, is at best a secondary concern that can never be put before protection of investors and the markets.

A. The Reporting Threshold Must Include Economically Equivalent Derivative Positions to Ensure That the Commission and the Public Receive Adequate Information on Short Sales

The SEC is explicitly proposing to allow institutional investment managers to exclude derivatives positions from the calculation of short positions for purposes of determining whether they meet the proposed reporting thresholds. The SEC asks two critical questions with regard to this aspect of the Proposal. The first is "Do you believe that Managers would try to avoid triggering the proposed Reporting Thresholds?"[34] The answer to this question is almost certainly a resounding "yes." This is not to suggest anything untoward about institutional investment managers, except that they are almost certainly practical, smart, and creative. The SEC correctly identifies several reasons why institutional investment managers would not want to be subject to reporting requirements. Reporting will require mangers to bear some costs, and as for-profit businesses, institutional investment managers certainly want to decrease costs that eat into their

[34] Release at 14,969.

profits.[35] Institutional investment managers may also have concerns that public reporting of their short positions may result in copycat trading that may undermine profits, retaliation from issuers (or, in light of the GameStop frenzy, from certain segments of the investing public), or other negative consequences.[36] Even if these burdens are likely to be relatively minor for institutional investment managers, they will almost certainly try to avoid them if given a legal means to do so while still largely engaging in the same profitable activity. Given an inch, institutional investment managers may not take a mile, but given the entire mile through an exemption, they almost certainly will. The SEC candidly acknowledges this by noting there is evidence that, in fact, when faced with restrictions or other burdens on short selling, "investors have used options to circumvent" those burdens.[37]

This basic fact about incentives makes answering the second critical question relating to this aspect of the Proposal an easy task. The question posed is "Should a Manager also be required to include short positions resulting from derivatives in determining whether it meets the Reporting Thresholds?" Based on the incentives described above, the answer is a clear, resounding, unequivocal, and unambiguous "yes." Because institutional investment managers, like most businesses, will attempt to reduce their costs of doing business while increasing profits, it can be readily expected that if given the opportunity to avoid a reporting requirement that costs money and threatens to reduce profits, they will take it. Allowing institutional investment managers to exclude functionally equivalent derivatives positions is providing just such an opportunity. The SEC recognizes this in the Release, identifying as a potentially "high" risk that managers may attempt to circumvent the reporting requirement by trading in derivatives instead of engaging in direct short sales, although the two are functionally equivalent. If, as is reasonable to expect, a significant number seize that opportunity, the result will be that the SEC and the public will not have meaningful insight into short positions. The entire goal of the Proposal, as stated by the SEC, is "to provide greater transparency" into short positions, yet this goal is directly undermined by the proposed exclusion. If the Proposal is finalized with this exclusion, it will mean that the SEC and the public will be blind to significant levels of risk building up in the financial system from short positions, will have trouble responding to any short-sale driven market events as they are

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35 Release at 14,974.

36 Release at 14,954-55. These concerns would seem to be largely overblown in light of the Proposal that short sale data be aggregated across managers and published on a delay would mitigate many of these harms. *Id.* Accordingly, the SEC must not further weaken the reporting requirements in response to these supposed concerns, absent compelling evidence that the Commission's fairly lenient proposed approach has not already effectively done so.

37 Release at 15,001. The SEC is almost certainly correct that there would not be a one-to-one tradeoff of institutional investment managers migrating from directly holding short positions in a security to holding the functional equivalent in a derivative to avoid triggering the reporting threshold, because derivatives may not be available for a particular security, or transaction costs may be too high relative to directly shorting the stock. *See* Release at 15,001. However, it does not necessarily have to be the case that managers replace 100% (or even a majority) of transactions that would have been direct short sales with a functionally equivalent derivative for the derivatives exclusion to undermine the goal of the Proposal. Any unseen, unaccounted for risk could be potentially dangerous, and as it is, the SEC already estimates that the thresholds it is proposing would result in 11% of the dollar value of short positions not being reported. Release at 14,963.

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ongoing, and will struggle to piece together what actually happened in the aftermath. In other words, if finalized as proposed, the SEC risks inviting yet more destabilizing GameStop frenzies.

While the Release acknowledges this "significant risk" of attempted circumvention it is inviting by proposing such a massive loophole to the reporting requirements, it does not meaningfully attempt to justify it, at least not in terms of its primary missions of protecting investors and the markets. Instead, it appears that the SEC arrived at this approach primarily out of concern for reducing operational costs and complexities for institutional investment managers:

> "The Commission believes that this [excluding derivatives from the threshold calculation] is a simple and straight forward approach for Managers to determine whether they meet Threshold A that avoids any additional cost and complexity of including derivative or long positions."[38]

In other words, the Commission considered two approaches: (1) excluding derivatives from the threshold calculation, which involves a "high" and "significant" risk of circumvention, undermining the transparency that is the entire purpose of the rule;[39] or, (2) including derivatives, which would bolster the public benefits of the rule by ensuring the true risk of short positions is publicly reported, but which might not be as "simple and straight forward" an approach for institutional investment managers, who will have to incur some incremental "additional cost and complexity" from including derivatives positions.[40] The Commission chose to propose the one that posed "significant risk" of undermining the fundamental goal of the Proposal and depriving the public of the full benefits of the rule. This is exactly backwards. The Commission's primary concern should be providing maximum public benefit, not helping pad private profits by marginally reducing the costs and complexities of regulation for the benefit of hedge funds and others at the expense of the public. In order for the final rule to actually serve its purpose, it must require that institutional investment managers include their short interest that arises from derivatives positions.

B. The SEC Should Strengthen the Disclosure Requirements

Once the SEC eliminates the unjustifiable exclusion of derivatives from the reporting threshold, it will have crafted a rule that can be expected to meaningfully improve transparency into short positions and better enable the SEC and the public to understand the nature of short positions in stocks, ultimately reducing risk, bolstering market integrity, and enhancing the SEC's ability to respond to short-sale-driven market events. However, there are some aspects of the Proposal that, while they may not pose the same threat to the efficacy of the rule as the exclusion of derivatives positions from the reporting threshold, should still be strengthened to maximize the expected public benefits of the rule.

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38 Release at 14,962.
39 Release at 15,001.
40 Release at 14,962.

1. Eliminate or at Least Reduce the Reporting Thresholds

The first of these relates to the reporting thresholds. The SEC is generally proposing requiring that institutional investment managers report (1) any gross short position worth $10 million or more during any settlement date during the reporting month; or (2) a monthly average gross short position that represents 2.5% or more of shares outstanding in the security.[41] Based on its past experience temporarily requiring reporting of short positions during the financial crisis, the SEC estimates that those thresholds will capture about 78% of institutional investment managers, and 89% of the dollar value of short positions—meaning a full 11% of the dollar value of short positions would not be reported.[42] So while a substantial majority of the dollar value of short positions would be represented at the proposed thresholds, the 11% (or more) falling outside the reporting requirement would represent short positions still in the shadows, largely out of sight of the SEC and the public. That represents a significant amount of unreported and unknown short interest along with the hidden attendant risks.

According to the SEC's data, simply reducing the monthly gross position threshold from 2.5% to 0.5% would result in 5% of short position dollar value being unreported, a reduction of unreported activity of over 54%, while capturing about 8% more managers. Further reducing the dollar threshold to $5 million would result in the Proposal capturing 98% of the dollar value of short positions, further reducing the dollar value of unreported positions by 60%, while capturing fewer than 1% more managers.[43] This would represent a significant reduction of the risk arising from hidden short positions. And, of course, the risk of unreported short positions would be effectively eliminated (save for illegal failures to report by institutional investment managers) if there were no threshold, and all short positions (and substantially similar derivatives positions) were required to be reported.[44]

As it finalizes the Proposal, the SEC should eliminate the proposed thresholds so as to reduce or eliminate the risk that unknown, hidden short positions could pose to investors and the markets. That approach would adhere most closely to the letter and spirit of the Dodd-Frank Act, which requires the SEC to prescribe rules providing for the public disclosure of short sale information, without reference to thresholds or de minimis exceptions. If it decides to adopt any threshold, it must offer a justification, including an explanation as to why the unseen short interest facilitated by including a reporting threshold does not pose a significant risk to investors, markets, or the public.[45] And if the SEC retains a threshold, it should at a minimum substantially reduce it.

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[41] Release at 15,015.

[42] Release at 14,963. As the SEC acknowledges, for a variety of reasons, its estimate may actually overstate how much of the dollar value would get reported at the proposed thresholds. *Id.* n.80.

[43] Release at 14,963-64.

[44] *See* Release at 15,007-08 (explaining potential reductions in the reporting threshold).

[45] This explanation should also account for the probability that some managers will certainly reduce their short activity to avoid triggering the threshold, meaning there will almost certainly be some unknown amount of hidden short activity for any given threshold above the estimates in the Release.

2. *Make Published Data More Usable*

The other aspect of the Proposal the SEC should strengthen is the way it disseminates the reported data. Specifically, the SEC proposes to publish data on an aggregated basis, by security, without identifying which individual manager holds what positions, and also to publish such information with a fairly significant delay.[46] The primary impetus for this approach appears to be the Commission's concerns that publishing data that is more current or that identifies by name the managers who hold the relevant positions, or both, could result in "copycat" trading, make it easier for issuers to retaliate against short sellers or assist other investors in targeting short sellers for a short squeeze.[47] These are not specious concerns—copycat trading could cause a cascading downward price spiral in a stock, imposing losses on investors, not to mention other deleterious impacts on the issuers' other stakeholders. The GameStop frenzy illustrated all too well the destabilizing effect when investors target short sellers.

However, these provisions come with obvious and problematic tradeoffs, in that the published information will be less timely and less informative. Unfortunately, it appears that the Commission has struck the wrong balance, straining further than necessary to address the perceived threat posed by copycat trading. It is significant, for example, that the EU adopted a short sale reporting regime that essentially requires "immediate public disclosure of large short positions," by individual issuer.[48] Notwithstanding this more transparent approach, a study of the impact of the EU's regulation finds no evidence that the disclosure requirements have resulted in increased coordination or have resulted in short sellers being targeted for short squeezes.[49] There may be differences in the EU's securities markets that make this outcome more likely than it would be in the U.S., and there may be other concerns surrounding this and other aspects of the EU's approach. Nevertheless, the EU's experience with publishing much more comprehensive, specific, and current information is strong evidence that the SEC could significantly enhance the usability of short position information published under the rule without inviting some of the more damaging unintended consequences that led to its inhibited approach to disclosure. At the very least, the SEC must explain its approach in light of the EU's experience. Moreover, the EU's experience

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[46] *See* Release at 14,960-62. Managers would be required to file Form SHO within 14 days of the end of the reporting month. Release at 14,961. The SEC estimates it will publish aggregated within the end of the calendar month.

[47] Release at 14,955; Release at 14,990. Also relevant is that Section 929X of the Dodd-Frank Act requires the publication of aggregated data. 15 U.S.C. § 78m(f)(2). However, nothing in Section 929X *prohibits* additional publication of disaggregated or non-anonymized data, and the SEC otherwise has ample rulemaking authority under other statutory provisions to publish such data. *See* 15 U.S.C. § 78j(a)(1) (prohibiting any person from engaging in short sales "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.").

[48] Charles M. Jones, Adam V. Reed, and William Waller, *Revealing Shorts an Examination of Large Short Position Disclosures,* 29 Rev. of Fin. Studies 3278, 3279 (2016).

[49] Charles M. Jones, Adam V. Reed, and William Waller, *Revealing Shorts an Examination of Large Short Position Disclosures,* 29 Rev. of Fin. Studies 3278, 3282 (2016).

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demonstrates that there is no credible basis for the SEC to further weaken the usability of the data it will publish in response to these concerns.

II. THE SEC SHOULD FURTHER STRENGTHEN THE REGULATION OF SHORT SALES AND SHORT ACTIVITY

Although Better Markets recognizes that the Proposal is primarily concerned with transparency, not with any substantive requirements applicable to short sales, there are a number of other substantive requirements the SEC can, and should, consider, whether in this rule or a future rulemaking, to address potential risks and opportunities for abuse in the short selling market. Implementing these policies will enhance market integrity and reduce risk in the financial system resulting from short sales.[50]

A. Eliminate Exceptions to the Locate Requirement

We fully support the SEC's proposal to require that broker-dealers report when they are relying on the "bona fide market maker" exception from the locate requirements of Regulation SHO.[51] This will help the SEC better monitor for violations of Regulation SHO, including abuse of the bona fide market maker exception. However, the SEC should consider simply eliminating this exception. The SEC has correctly concluded that naked short sales are abusive.[52] The SEC established this loophole, which permits the largest proprietary trading firms to engage in naked short selling, on the theory that it facilitates trading in hard-to-borrow securities. However, the SEC's settlement regulations with respect to mandatory buy-ins already provide special accommodations to market-makers that cannot close out their short positions within the standard failure-to-deliver close-out timeframe.[53] This accommodation already in place calls into serious question whether the large loophole in the locate requirement serves any legitimate purpose. At the very least, the SEC must closely monitor the information it receives regarding reliance on this exception to determine whether elimination of this exception is warranted.

B. Impose Short Position Accountability and Position Limits

Another potential tool for reducing the potentially destabilizing impact of short sales is to establish a net short position accountability and position limits framework, along with a special filing requirement for market participants that have net short positions, at least in hard-to-borrow equities above a certain threshold relative to the total tradeable float in a security. Stocks experiencing aggregate short interest above 90 percent of the tradeable float in the security, for example, should trigger the imposition of this position limits framework. Such a tool would be

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50 *See generally* BETTER MARKETS, SHORT SELLING: 10 RECOMMENDATIONS FOR IMPROVING THE SEC'S REGULATORY FRAMEWORK (May 4, 2021), https://bettermarkets.org/analysis/short-selling-10-recommendations-improving-sec-s-regulatory-framework/.

51 Release at 14,952.

52 Release at 14,986.

53 17 C.F.R. § 242.204(a)(3).

extraordinarily effective at preventing large short positions from having serious, destabilizing market impacts, such as what GameStop and other meme stocks experienced in January 2021.

C. Reimplement the Uptick Rule

The SEC should also consider reinstituting the "uptick rule," which

> "provided that, subject to certain exceptions, a listed security could be sold short (i) at a price above the price at which the immediately preceding sale was effected (plus tick), or (ii) at the last sale price if it was higher than the last different price (zero plus tick)."[54]

This rule ameliorated price declines associated with short selling for almost 70 years without significant effects on the development of the U.S. capital markets. Its abandonment just prior to the financial crisis has been described by one commentator as "a complete repudiation of its longstanding judgment that unrestricted short selling could be dangerous in a falling stock market."[55] Indeed, eliminating the rule was unnecessary and ill-conceived. The SEC eliminated the rule in 2007, arguing that it was unnecessary because "today's markets are characterized by high levels of transparency and regulatory surveillance" which "greatly reduce[s] the risk of undetected manipulation and permit[s] regulators to monitor for the types of activities that current price test restrictions are designed to prevent."[56] The folly of those assertions would be revealed over the next few years, as first the financial crisis, and then the revelation of Bernie Madoff's massive Ponzi scheme, revealed that the SEC severely overestimated the actual level of market transparency as well as its ability to detect and prevent widespread fraud, abuse, and market disruptions.[57]

Recognizing the utility of a price test to prevent substantial price declines from short sales, the SEC instituted an "alternative uptick rule," described above, that establishes an uptick rule, but only in stocks that have undergone a single day price decline of at least 10%.[58] Although there is merit to this alternative to the full uptick rule, we are not persuaded that a single-day 10 percent downturn in a company's share price should be required to reinstate uptick requirements on short selling.

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54 Amendments to Regulation SHO, 75 Fed. Reg. 11,232 (Mar. 10, 2010).

55 Melissa W. Palombo, *Why A Short Sale Price Test Rule Is Necessary in Today's Markets*, 75 BROOK. L. REV. 1447, 1449 (2010).

56 Regulation SHO and Rule 10a-1, 72 Fed. Reg. 36,348 (Jul. 3, 2007).

57 Melissa W. Palombo, *Why A Short Sale Price Test Rule Is Necessary in Today's Markets*, 75 BROOK. L. REV. 1447, 1477 (2010).

58 Release at 14,987.

D. Impose Mandatory Buy-Ins and Punitive Fee Assessments to Ensure Operational Integrity

The SEC must continue to require clearing broker-dealers to immediately close out failures-to-deliver ("FTDs") during the settlement process. This should include mandatory buy-in-processes, along the lines of what has been established in the EU:

> "Under Article 15 of the Regulation, a central counterparty in a Member State that provides clearing services for shares shall monitor whether a short seller fails to deliver the shares within four business days after the day on which settlement is due. If not, procedures are automatically triggered for the buy-in of the shares to ensure delivery for settlement. When the central counterparty is not able to buy-in the shares, an amount is paid to the buyer based on the value of the shares to be delivered at the delivery date, plus an amount for losses incurred by the buyer as a result of the settlement failure. The short seller will reimburse all amounts paid."[59]

The SEC should also bolster mandatory buy-ins with fee assessments designed to punish and deter firms with FTDs that are not closed out timely under Regulation SHO. Fee assessments should climb as the outstanding period for a short-selling-related FTD lengthens.

CONCLUSION

We hope these comments are helpful as the Commission finalizes the Proposal.

Sincerely,

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59 Rodolphe B. Elineau, *Regulating Short Selling in Europe After the Crisis*, 8 B.Y.U. INT'L L. & MGMT. REV. 63, 80–81 (2012)

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