The SEC's Proposed Rule for Securities Lending Transparency

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I. Overview of the Proposed Rule

1. On November 18, 2021, the United States Securities and Exchange Commission ("SEC" or "Commission") issued for public comment a proposed rule under the Securities Exchange Act of 1934 regarding the reporting of securities loans. Under the proposed rule, securities lenders[1] would be required to provide the "material terms of lending transactions" to a registered national securities association ("RNSA") such as the Financial Industry Regulatory Authority ("FINRA") "within 15 minutes after each loan is effected or modified."[2] The data elements to be provided to the RNSA include identifiers for the security involved; the date and time of the transaction; the amount and terms of the loan, including pricing and collateral; the platform where the transaction took place; and the type of borrower (e.g., broker-dealer).[3] The RNSA would be required to create a unique transaction identifier for each transaction and publicly disseminate the information "as soon as practicable."[4] Lenders would also be required to provide information on modifications to prior transactions, including "the date and time of the modification, a description of the modification and the unique transaction identifier assigned to the original loan, if any."[5] At the end of each business day, lenders would also be required to provide data on the aggregate amounts of each security available to loan and on loan, which the RNSA is required to

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[1] The Commission uses the terms such as "loan" and "lender" in reference to market transactions that are not necessarily considered loans. For simplicity, my report adopts the Commission's terminology: "Lender, when used in this release, refers to any persons that loans a security on behalf of itself or another person, including persons that own the securities being loaned ('beneficial owners'), as well as third party intermediaries, including banks, clearing agencies, or broker-dealers that intermediate the loan of securities on behalf of beneficial owners ('lending agent')." "Proposed Rule: Reporting of Securities Loans," Release No. 34-93613, *SEC*, November 18, 2021 ("Proposing Release"), footnote 9.

[2] Proposing Release, pp. 22–23, 41.

[3] The specific data elements to be provided to the RNSA include: "(1) the legal name of the security issuer, and the Legal Entity Identifier ('LEI') of the issuer, if the issuer has an active LEI; (2) the ticker symbol, ISIN, CUSIP, or FIGI of the security, if assigned, or other identifier; (3) the date the loan was effected; (4) the time the loan was effected; …(5) for a loan executed on a platform or venue, the name of the platform or venue where executed[;] …(6) the amount of the security loaned; (7)[] for a loan not collateralized by cash, the securities lending fee or rate, or any other fee or charges[]; (8) the type of collateral used to secure the loan of securities; (9) for a loan collateralized by cash, the rebate rate or any other fee or charges; (10) the percentage of collateral to value of loaned securities required to secure such loan; (11) the termination date of the loan, if applicable; and (12) whether the borrower is a broker or dealer, a customer (if the person lending securities is a broker or dealer), a clearing agency, a bank, a custodian, or other person." *See* Proposing Release, pp. 45, 47.

[4] Proposing Release, pp. 41, 44.

[5] Proposing Release, p. 51. Lenders would also be required to provide information on the parties to each trade, which would not be disseminated publicly by the RNSA. *See* Proposing Release, pp. 53–54.

aggregate across lenders and disseminate by no later than the end of the following business day.[6]

2. The Commission claims that the "securities lending market is characterized by asymmetric information between market participants and a general lack of information on current market conditions, which can lead to inefficient prices for securities loans" and states that the rule would increase transparency in the securities lending market.[7] It posits various benefits of increased transparency, such as improved price discovery, better risk management, and reduced trading costs.[8] To support its claims, the Commission cites research on the effects of the introduction of TRACE on the corporate bond market and research from Brazil purportedly showing "that improving securities lending transparency led to lower fees, increased liquidity, and increased price efficiency."[9]

3. The Commission asserts that "the proposed Rule would also likely reduce the cost of short selling, leading to improved price discovery and liquidity in the underlying security markets."[10] The Commission states:

> *"[T]he improved information that would result from the proposed Rule would lead to increased profits for certain investors by increasing their certainty regarding investment strategies that require borrowing securities. Prior to a short sale transaction, the end borrower will be able to get a better sense of the likely costs associated with such an investment strategy, using the information that would be provided under the proposed rule. This increase in certainty regarding the costs of borrowing a security may decrease risk, and thereby increase risk-adjusted profits, of pursuing investment strategies that require short sales."*[11]

4. The Commission also claims that "reduced costs to short selling would benefit investors by enabling them to profitably engage in more fundamental research," citing to academic research that purportedly "indicates that when short selling costs diminish, investors will do more fundamental research because it is easier to trade on their information if they uncover negative information."[12]

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[6] Proposing Release, pp. 56–57.
[7] Proposing Release, pp. 106–107.
[8] Proposing Release, pp. 131–133.
[9] Proposing Release, pp. 129–130.
[10] Proposing Release, p. 106.
[11] Proposing Release, p. 132.
[12] Proposing Release, pp. 136–137.

II. The Commission Fails to Properly Consider Whether the Proposed Rule Will Promote Efficiency

5. Section 3(f) of the Exchange Act requires the Commission, when it engages in rulemaking, to consider or determine whether a regulatory action will promote efficiency, competition, and capital formation.[13] Here, the proposed rule assumes that by requiring information producers (that is, investors who produce information by researching trading opportunities) to publicly disclose their proprietary trading information to information consumers (that is, investors who rely only on public disclosures of information) the result will be more "efficient." But the effect of the rule is likely to involve a tradeoff: while information consumers may be better off, information producers are worse off. This tradeoff is referred to in the economics profession as a "distributional effect" or "wealth transfer," which is not by itself efficiency enhancing.

6. The reason why a wealth transfer likely exists is because the information producers in this instance invest resources into costly research in order to privately produce information that they use for developing and implementing proprietary trading strategies. The Commission's proposal effectively requires information producers to publicly disclose proprietary information in close to real time, which can occur before they can fully execute their trading strategies. This effectively requires information producers to freely share the output of their costly research before they can lock in any benefits from it. All else equal, this will leave information producers worse off, while information consumers benefit from the public disclosure. To conclude that the proposed rule enhances efficiency by redistributing the benefits of proprietary research from one group of investors to another group of investors would require the Commission to evaluate the welfare impact of these tradeoffs—a task which the Commission has not performed.

7. As discussed in more detail in the next section, unlike for other post-trade anonymized disclosure regimes (e.g., TRACE), such a welfare analysis would also need to account for the response of information producers to the proposed disclosure requirements. The Commission states that "improved information access may also improve price discovery in the market for the securities underlying the security loans" and that this "may increase price efficiency by allowing a broader section of investors to learn from and trade based on

[13] 17 C.F.R. 240.3(f); Proposing Release, footnote 186.

signals obtained from the securities lending market."[14] However, the effect of the proposed rule on pricing efficiency would likely be just the opposite; if information producers optimally choose to reduce the amount of resources they allocate to producing information, the market (including information consumers) will be left with worse-quality information and less-informative security prices as a result of the proposed rule.[15] Academic research demonstrates that if the operation of the market for short selling is impaired, the result will be less informationally-efficient prices.[16]

III. The Commission's Assertion That the Proposed Rule Will Benefit Short Sellers Ignores Impacts that Are Likely to Harm the Securities Lending Market

8. There is a correlation between securities lending activity and short selling. For this reason, academics in finance have long looked to the securities lending market to examine short sale activity and its impact on stock returns.[17] They have modeled the demand for shorting stocks using granular stock lending data, and found that, for a given stock, increased shorting demand is an important predictor of future stock returns.[18]

9. Given the relationship between securities lending and short selling, it follows that proposed disclosure of granular information on securities lending transactions may affect short sale activity, particularly if this disclosure includes broker-dealers in the "[r]etail [m]arket," as described in the Proposing Release.[19] The Commission recognizes this, but claims that "the proposed Rule would …likely reduce the cost of short selling, leading to

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[14] Proposing Release, p. 133.

[15] The Commission notes that the "increase in securities lending information [caused by the proposed rule] would also result in costs in the form of lost revenue for current providers of commercial securities lending data." Proposing Release, p. 132. Faced with lower revenues, these providers, which include IHS Markit (formerly Data Explorers) and FIS (formerly Sungard), may alter their available product offerings in response to the proposed disclosure requirements. *See* Letter from Donal Smith (Data Explorers) to Elizabeth Murphy (SEC), "Dodd-Frank Financial Reform Act: Section 417(a)(2) Short Sale Reporting Study, RE: File Number 4-627," June 23, 2011.

[16] *See* Charles M. Jones et al., "Revealing Shorts An Examination of Large Short Position Disclosures," *The Review of Financial Studies* 29, no. 12, 2016, pp. 3278–3320 at p. 3299 ("We find that price delay increases after the beginning of the disclosure regime. …Since the previous literature suggests that short sellers increase price informativeness, the reduced presence of short sellers …is consistent with the reduction in price informativeness.").

[17] Gene D'Avolio, "The Market for Borrowing Stock," *Journal of Financial Economics* 66, 2002, pp. 271–306 at p. 274; Lauren Cohen et al., "Supply and Demand Shifts in the Shorting Market," *The Journal of Finance* 62, no. 5, 2007, pp. 2061–2096 ("Cohen et al. (2007)") at p. 2064.

[18] Using a data sample from an anonymous institution participating in stock lending, the authors identify an increase in the demand for stock shorting by the joint observation of an increase in stock loan fees and an increase in the percentage of shares on loan. Cohen et al. (2007), p. 2062.

[19] Proposing Release, pp. 15–16.

improved price discovery and liquidity in the underlying security markets."[20] In support of its claims, the Commission cites to academic research on the effects of the implementation of TRACE on the corporate bond market and research on the impact of a securities lending disclosure rule in Brazil. However, neither research stream is applicable in this instance, as discussed below. Indeed, academic studies of the effect of rules mandating disclosure of short sales and short positions suggest that the effect of such rules on market quality is negative rather than positive, as traders adjust their behavior to avoid the adverse effects of disclosing their strategies.[21]

A. The Studies Cited by the Commission Do Not Support Its Claim That the Proposed Rule Would Lower the Cost of Short Selling

10. The Commission asserts that the proposed disclosure rule would result in a reduction in the cost of borrowing securities and "improvements in efficiency in the securities lending market[, which] would reduce the cost of short selling, potentially affecting markets more broadly."[22] The Commission also asserts that a reduction in the cost of borrowing securities may increase certain investors' returns "as it will facilitate investment, hedging, and potentially market making strategies."[23]

11. To support these assertions, the Commission relies on two pieces of empirical evidence. First, the Commission makes reference to the implementation of TRACE disclosure rules and their impact on transparency and transaction costs in the corporate bond market. Second, the Commission cites "recent research from Brazil [that] has shown that improving securities lending transparency led to lower fees, increased liquidity, and increased price efficiency."[24] The Commission's reliance on these pieces of empirical evidence is misplaced.

12. The Commission speculates that "the transparency created by the proposed Rule" would be consistent with the experience of improved transparency in the corporate bond

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[20] Proposing Release, p. 106.
[21] *See, e.g.* Stephan Jank et al., "Flying Under the Radar: The Effects of Short-Sale Disclosure Rules on Investor Behavior and Stock Prices," *Journal of Financial Economics* 139, no. 1, 2021, pp. 209–233 ("Jank et al. (2021)").
[22] Proposing Release, p. 128.
[23] Proposing Release, p. 128.
[24] Proposing Release, pp. 129–130.

market after the implementation of TRACE.[25] It cites research that has shown TRACE lowered both the average cost of transacting as well as the dispersion of transaction costs. However, the Commission's reliance on the TRACE studies is misplaced for two reasons.

13. First, the Commission ignores the difference between secondary market transactions in bonds and securities loans. The data publicly disclosed through TRACE pertain to secondary market trades in corporate bonds. Secondary market bond transactions are irrevocable and fungible. The terms of the transactions are generally not dependent on the identities of the transacting parties. It does not matter from which party one buys a bond in the secondary market. Securities lending transactions, in contrast, are revocable and unique and are more akin to primary market borrowing transactions. The identity and characteristics of the party from whom one borrows a security or to whom one loans a security have an impact on the terms of the loan. For example, the value of the loan to the borrower depends in substantial part on the lender's propensity to recall the loan because the lender can recall the loan at will. Similarly, the lender faces credit risk because the borrower may fail to repay the loan. Accordingly, transaction reporting in the securities lending market is very different from transaction reporting in the bond market. The fact that one market participant borrowed a security at a certain rate is not necessarily informative about the value of a loan with a different market participant. In other words, securities lending rates will carry more idiosyncratic noise and will likely not be as informative as the secondary market prices of bonds.[26]

14. Second, the Commission should consider that while there is no reason for the supply of corporate bonds to decrease in response to increased trade transparency, greater transparency in the securities lending market may well reduce the lending supply. For example, industry studies have found that manager-level public short selling disclosure requirements "result[] in beneficial owners reducing the lendable equity supply and thus reducing market capacity for stock lending."[27] Indeed, even the study cited by the

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[25] Proposing Release, p. 129.

[26] "The Commission recognizes that …the data will not contain all information necessary to perfectly compare the fees on different loans, though the Commission preliminarily believes that the proposed Rule improves the ability to compare loans. For example, …loan fees are determined by a variety of factors including counterparty creditworthiness – which is not captured in the proposal's data. As such, two loans could appear to be similar in the information the proposed Rule would provide, but the counterparty risk differences could result in different fees." Proposing Release, pp. 135–136.

[27] *See* "The Effects of Short-Selling Public Disclosure Regimes on Equity Markets," *Oliver Wyman*, 2010, pp. 4, 16–17 ("[A]fter the imposition of a public [short selling disclosure requirement], the available quantity for loan deteriorated a further 8% in the UK market. This additional decrease in lendable quantity is most likely due to

Commission to support its claim states that the "overall positive effects of greater price transparency presented in the existing empirical literature [on corporate bonds] cannot be directly extrapolated to equity lending since greater loan fee transparency could reduce the lending supply."[28]

15. The Commission's reliance on evidence from a 2011 policy change affecting the Brazilian equity lending market is also misplaced. The policy change in Brazil that allegedly improved transparency in the Brazilian equity lending market is simply not comparable to the proposed rule. The Brazilian policy change pertained to a reduction in the time interval over which a fee benchmark for stock loan transactions was calculated.[29] It did not involve the trade-by-trade disclosure of stock lending terms as foreseen in the proposed rule. Such granular data were not publicly disclosed in Brazil. Therefore, the Commission cannot rely on the Brazilian policy change to draw inferences about U.S. market participants' reaction to the proposed rule and the granular disclosures it foresees. As discussed next, such granular disclosures pose a threat to market participants' proprietary investment strategies.

B. Academic Research Suggests That Disclosure of Short Sales and Short Positions Adversely Impacts the Functioning of the Stock Lending Market and Price Discovery

16. In addition to its misplaced reliance on academic studies related to TRACE and the Brazilian securities lending market, the Commission also errs in failing to consider recent empirical evidence by Jank et al. (2021), published in the *Journal of Financial Economics*, on how investors react to granular trade-level disclosure requirements. Their empirical analysis, based on a policy change in Europe, is directly relevant to the proposed rule, and highlights some of the adverse effects that the proposed rule should be expected to have on the functioning of the stock lending market and on price discovery.[30]

17. In 2012, the European Union ("EU") adopted a rule requiring investors to "publicly disclose any net short position that reaches a threshold of 0.5% of the shorted stocks' issued

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an increased aversion of beneficial owners (e.g., pension funds, long-only asset managers, etc.) to lend their stocks for the purpose of short selling.").

[28] Fabio Cereda et al., "Price Transparency in OTC Equity Lending Markets: Evidence From A Loan Fee Benchmark," *Journal of Financial Economics*, forthcoming, 2021, pp. 1–63 at p. 6.

[29] Fabio Cereda et al., "Price Transparency in OTC Equity Lending Markets: Evidence From A Loan Fee Benchmark," *Journal of Financial Economics*, forthcoming, 2021, pp. 1–63.

[30] Jank et al. (2021).

share capital one day after that position was acquired."[31] The disclosures contain "the name and identifier of the shorted stock, the identity of the short seller, and the date and magnitude of the position."[32] If a short position reaches a threshold of only 0.2% of the shorted stock's issued share capital, investors must file a confidential notification with the regulator, without a public disclosure.

18. Jank et al. (2021) examine how these disclosure requirements affected investors' behavior, and find "strong evidence that a significant share of positions accumulated just below the disclosure threshold."[33] They link this disclosure avoidance to hedge funds' desire to protect their strategies from reverse engineering by competitors and protect their profitability. Importantly, the researchers also document that the disclosure threshold discouraged informed investors, including hedge funds, from increasing their short positions, resulting in stock prices that reflected negative news more slowly than they would have without the policy change. Thus, the introduction of trade-level disclosure requirements reduced price discovery in the underlying stock.[34]

19. Another academic study by Duong et al. (2015) also finds that mandatory disclosure of short positions has negative effects on market quality.[35] The authors study the impact of a market-wide mandatory short selling disclosure policy on the Tokyo Stock Exchange. Under the policy, traders were required to report all short positions in excess of 0.25% of the company's shares outstanding to the exchange within 24 hours of acquiring the position. The information was then publicly disseminated within another 24 hours. The authors find that after the disclosure policy came into effect:

> *"average short selling slightly declined while investors' shorting strategies changed significantly in response to the disclosure. Previously highly shorted stocks were shorted less and shorting activity shifted toward smaller and riskier stocks, suggesting that retail investors became the more likely short sellers. Short sales became more trend-chasing, prices became less informative, and short-term price volatility increased. Overall, the pricing efficiency benefits of short selling declined after the mandatory disclosure policy."*[36]

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[31] Jank et al. (2021), p. 210.
[32] Jank et al. (2021), p. 210.
[33] Jank et al. (2021), p. 210.
[34] The findings from Jank et al. (2021) are consistent with other research on the EU policy change. Studying the same event, Jones et al. (2016) find "that the disclosure regime reduces short interest and the informativeness of prices." *See* Charles M. Jones et al., "Revealing Shorts An Examination of Large Short Position Disclosures," *The Review of Financial Studies* 29, no. 12, 2016, pp. 3278–3320.
[35] Truong X. Duong et al., "The Costs and Benefits of Short Sale Disclosure," *Journal of Banking & Finance* 53, no. 1, 2015, pp. 124–139 ("Duong et al. (2015)").
[36] Duong et al. (2015), p. 124.

Thus, the authors document numerous negative effects of the disclosure policy, resulting from the rational behavior of investors in response to the policy.

20. While the empirical evidence in Jank et al. (2021) and Duong et al. (2015) pertains to disclosures of short sales as opposed to securities lending (which is at-issue here), as discussed above, academic research has demonstrated that changes in the demand and supply for short sales can be inferred from granular securities lending data (which the proposed rule considers subjecting to mandatory disclosures).[37] Thus, the downstream effects of securities lending disclosure can be inferred from these academic studies.

C. The Commission Has Failed to Account for Potential Harmful Consequences of the Proposed Rule

21. As previously discussed, the proposed rule will in the first instance result in a transfer of information and wealth from information producers to information consumers, but this transfer can ultimately impair market quality more broadly. This transfer of information will have adverse consequences for the profitability of the trading strategies of information producers, which could lead to a weakening of the incentives to engage in costly research, and a scaling back of their activities, for such investors. While the Commission acknowledges that the disclosure requirements in the proposed rule "may affect the profitability of certain trading strategies,"[38] and "may somewhat diminish the value of collecting and trading on negative information,"[39] it fails to consider how the diminished profitability of certain trading strategies may reduce investors' incentives to borrow securities and arrange short sales, with the likely result of impaired price discovery and increased price volatility, i.e., a deterioration rather than an improvement in market quality.

22. The proposed rule may negatively affect the profitability of trading strategies that involve short sales in several ways. First, the proposed rule may facilitate "copycat strategies." For example, if granular data on securities loans become available to the market within 15 minutes of the transaction, and the data enable investors to predict the extent of short selling pressure on each security (as the Commission argues and as documented by Cohen et al. (2007)), then short selling strategies that take time to execute are less likely to be

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[37] Cohen et al. (2007).

[38] Proposing Release, p. 107.

[39] Proposing Release, p. 138.

profitable as the market may be able to anticipate the intentions of the trading strategies and copy them.[40]

23. The Commission has recognized that "copycat" risk could "ultimately degrade price efficiency" in its 2014 study of the feasibility, benefits, and costs of "requiring the reporting of short sale positions in publicly listed securities in real time."[41] Specifically, the Commission recognized that "[t]o the extent that copycat traders could detect fundamental short selling in [the granular short sale data], they could mimic fundamental short sellers and profit from their research without incurring the cost of that research. Such activity could reduce the profits available to fundamental traders, because copycat trading might move prices before fundamental traders could fully build their planned positions."[42] Even if the anonymous nature of the proposed disclosures offers some protection against copycat risk, certain market participants may leverage sophisticated pattern recognition software based on machine learning techniques to detect other market participants' trading strategies.[43]

24. Moreover, as the proposed rule notes, market participants already have access to certain data on stock lending and short sales (some of which are freely available, and some of which are available for a fee).[44] Thus, the disclosures foreseen in the proposed rule add significant additional transparency to a market that is already characterized by some level of transparency, making it easier to detect and copycat short sale strategies. The Commission has acknowledged this risk of copycatting in another proposed rule related to reporting of short selling transactions.[45] In the proposing release for the short selling rule, the Commission states that "a shorter delay [for releasing the aggregated short position data] increases the likelihood of copycat behavior which decreases the incentive that short sellers have to gather information potentially leading to lower price efficiency and greater volatility."[46] This concern is not just hypothetical. In a 2017 release on its machine learning

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[40] Cohen et al. (2007).

[41] "Short-Sale Position and Transaction Reporting: As Required by Section 417 of the Dodd-Frank Wall Street Reform and Consumer Protection Act," *SEC*, June 5, 2014 ("Short Sale Position and Transaction Reporting"), pp. i, 51.

[42] Short Sale Position and Transaction Reporting, p. 51.

[43] "Concept Release: Equity Market Structure," Release No. 34-61358, Federal Register 75, no. 13, January 21, 2010, pp. 3594–95.

[44] Professional data vendors such as IHS Markit (formerly Data Explorers) and FIS (formerly Sungard) currently offer daily data on securities lending transactions to subscribers. *See* Proposing Release, pp. 20–21, 116–118, 124–125; Letter from Donal Smith (Data Explorers) to Elizabeth Murphy (SEC), "Dodd-Frank Financial Reform Act: Section 417(a)(2) Short Sale Reporting Study, RE: File Number 4-627," June 23, 2011.

[45] *See* "Proposed Rule: Short Position and Short Activity Reporting by Institutional Investment Managers," Release No. 34-94313, *SEC,* February 25, 2022, ("Proposing Release on Short Position and Short Activity Reporting").

[46] Proposing Release on Short Position and Short Activity Reporting, p. 187.

capabilities, J.P. Morgan noted that its "quant team used global data to determine which stocks had high lending rates, assuming strong demand was being driven by short selling," and reported that it subsequently successfully implemented an approach to "[follow] the short interest herd."[47]

25. Another way in which the proposed rule may negatively affect the profitability of trading strategies that involve short sales is by facilitating short squeeze strategies. A short squeeze is a situation in which prices are pushed upward to force short sellers out of their positions. As prices are pushed higher, short sellers are required to add cash to their margin accounts or close out their positions.[48] The Commission has acknowledged this risk of providing information that could be used to orchestrate a short squeeze in the proposing release for the short selling rule mentioned above. There, the Commission comments that aggregating the data and delaying their release to the public is a way to mitigate this type of risk, a solution which is not adequately considered in the securities lending Proposing Release.[49] The Commission thus appears inconsistent (across the proposing releases for securities lending and short selling) in its views on the importance of these concerns when evaluating the costs and benefits of trade-by-trade disclosures.

26. The idea that knowledge of short positions could lead to an attempted short squeeze is not purely hypothetical. For example, in January 2021, certain investors on a social media site executed a coordinated investment strategy to force a short squeeze in stocks that were identified as being heavily shorted, resulting in losses to investors with short positions in those stocks.[50] The Commission has made no attempt to show that the net effect will be

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[47] "Alternate Stock Lending with Unconventional Data," *J.P. Morgan*, June 23, 2017.

[48] "Staff Report on Equity and Options Market Structure Conditions in Early 2021," *SEC*, October 14, 2021, p. 25 ("A short squeeze might occur when an event triggers short sellers *en masse* to purchase shares to cover their short positions. For example, if there is a sudden increase in the price of the stock being shorted, short sellers would face margin calls requiring them either to post additional collateral or to exit their position. Short sellers that cover their positions by buying the underlying stock would cause additional upward price pressure on the stock, which could force other short sellers to exit their positions, adding further upward price pressure and so on.").

[49] Proposing Release on Short Position and Short Activity Reporting, p. 133 ("However, the delay before publicly releasing the data means that the information would not be as fresh and thus may not as accurately reflect current short positions. Thus, if market participants sought to orchestrate a short squeeze based on the aggregated information made public based on the Proposed Form SHO data[,] the squeeze could fail if the short positions that are the target of the squeeze no longer exist.").

[50] "In January 2021, retail investors on social media site Reddit's 'WallStreetBets' subchannel ('subreddit') collectively executed an investment strategy to induce a short squeeze in stocks such as GameStop, AMC and KOSS, as well as other securities they identified as being heavily shorted by hedge funds. Meaning, social media users collectively drove the stock prices up, forcing short sellers who bet the stock price would go down, to purchase shares at an increased price. …Initially, this squeeze led to heavy losses for some short sellers, particularly hedge funds, and led to substantial financial gain for some retail investors." Memorandum from FSC Majority Staff to Members, Committee on Financial Services, "February 18, 2021, Full Committee

beneficial in the securities lending market. Indeed, the research cited by the Commission to support its claims does not apply to the current instance and the research that more closely applies contradicts the Commission's claims.

D. The Commission Has Failed to Account for the Potential Consequences of Regulatory Arbitrage in the Securities Lending and Short Selling Markets

27. The Commission's economic analysis contained in the Proposing Release treats the securities lending market in the United States as if it sits in isolation from the rest of the world. The analysis fails to account for the consequences associated with the fact that the securities lending market operates across several jurisdictions around the globe. A report from the International Organization of Securities Commissions ("IOSCO") describes the global growth of securities lending activity over many years and concludes that this growth has resulted in increased market competition and lower lending rates.[51] In other words, the securities lending market in the United States does not sit in isolation from the rest of the world. The fact that the securities lending market operates across different jurisdictions is significant in understanding the economic impact of the proposed rule because it requires that the potential impact of regulatory arbitrage be considered. However, the potential consequences of regulatory arbitrage across jurisdictions are not addressed in the Proposing Release.

28. "Regulatory arbitrage" refers to financial transactions designed to reduce costs or capture profit opportunities created by differential regulations and is likely to occur in instances when regulated transparency regimes differ across jurisdictions. The proposed rule, if adopted, may result in the United States requiring greater transparency with respect to stock loans than what is required in certain other jurisdictions. In a globally connected market, market participants have the ability to choose the disclosure regime in which to trade. Informed traders can avoid the risk of having their information disclosed by choosing to trade

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Hearing entitled, 'Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide'?," February 15, 2021, p. 1.

[51] *See* "Securities Lending Transactions: Market Development and Implications," *Technical Committee of the International Organization of Securities Commissions (IOSCO), Committee on Payment and Settlement Systems*, July 1999, pp. 11, 14 ("[B]y the end of the 1980s, US global custodian banks, US securities firms and UK money lenders were starting to develop today's 'offshore' securities lending markets. These firms were able to effect securities lending transaction[s] outside the local market through settlement on the books of foreign subcustodians. This fed the increasing demands of US firms to borrow non-US securities to facilitate their trading in foreign derivatives markets, to effect dividend arbitrage strategies and to support their increasing appetite for foreign investment in general. … Leading firms are now active in as many as 25 markets.").

in more opaque jurisdictions. This would result in a decline in the informativeness of trades in the U.S. The consequence of traders engaging in regulatory arbitrage by opportunistically trading across jurisdictions with differing transparency regimes is known in the economics profession as "adverse selection." Adverse selection is an important factor to consider when evaluating the economic impact of a proposed rule because it implies that market quality is likely to be reduced in the regime requiring greater transparency. When it becomes known that market participants operating in opaque jurisdictions will opportunistically trade in the transparent jurisdictions, a likely result is that traders in the transparent jurisdictions will account for the possibility of adverse selection risk by adjusting their pricing. The adjustment of pricing, through the revision of bids and offers, is a well-known means for traders to manage adverse selection risk.[52] The possibility of adverse selection risk means that requiring greater transparency can impair market quality through higher trading costs, less reliable price discovery, and less liquidity resulting in impaired capital formation.[53] Moreover, the Commission has not considered whether these potential consequences of the proposed rule could result in a decline in trading volume and a less competitive U.S. market relative to foreign markets.[54]

29. Relatedly, the proposed rule does not adequately consider how market participants may circumvent the security lending disclosures, reduce their covered short sale activity, and instead engage in alternative trading strategies that synthetically replicate short sales.[55] Such synthetic strategies may involve options, and thereby affect the cost of trading in the options market.[56]

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[52] *See* Hans R. Stoll, "Inferring the Components of the Bid-Ask Spread: Theory and Empirical Tests," *The Journal of Finance* 44, no. 1, 1989, pp. 115–134. *See also* Itzhak Krinsky and Jason Lee, "Earnings Announcements and the Components of the Bid-Ask Spread," *The Journal of Finance* 51, no. 4, 1996, pp. 1523–1535 at p. 1525 ("If the specialist anticipates a greater probability of facing an informed trader in advance of earning releases, these models predict that the spread, and in particular the adverse selection component of the spread, should widen.").

[53] *See* Short Sale Position and Transaction Reporting, p. 14 ("[M]ore liquid markets also promote capital formation because investors prefer to invest capital in markets where establishing and liquidating positions can be done quickly and at low cost.").

[54] While the Proposing Release contains a section discussing the proposed rule's impact on competition, the Commission focuses its discussion on competition between market participants in the U.S. and does not consider the broader global context. *See* Proposing Release, pp. 149–151.

[55] I note that the Proposing Release discusses the "risk of circumvention through repurchase agreements" in which market participants would substitute repurchase agreements for securities lending agreements. The Commission does not, however, consider other alternative trading strategies available to investors. While "the Commission preliminarily believes that the current risk of such migration may be minimal because of the lack of a well-developed repo market for equities," the risk of migration to other alternatives may not be mitigated for the same reasons. *See* Proposing Release, p. 147.

[56] Robert Battalio and Paul Schultz, "Regulatory Uncertainty and Market Liquidity: The 2008 Short Sale Ban's Impact on Equity Option Markets," *The Journal of Finance* 66, no. 6, 2011, pp. 2013–2053.

IV. The Commission Fails to Jointly Consider the Possible Impact of Other Proposed Rules with Potentially Similar Indirect Costs

30. The Commission's considerations of the possible indirect consequences on price discovery discussed in the preceding sections are particularly lacking when these concerns are viewed jointly with other rules currently proposed by the Commission. In simultaneous rulemakings, the Commission is proposing to require—in many cases, for the first time ever—public reporting of securities lending transactions,[57] short sale activity,[58] and swaps positions.[59] These proposed rules represent a significant increase in transparency across three markets at the same time. The Commission is also proposing changes to the regulatory regime for beneficial owner reporting and a new current report to Form PF.[60] At the same time, the Commission is proposing fundamental changes to the way in which funds charge for their services and structure their relationships with investors.[61] The Commission fails to comprehensively consider the potential unintended effects that may occur from the interaction costs resulting from these closely-coupled rules being issued simultaneously (i.e. "knock-on effects").

31. The Commission cannot consider these rules in isolation because of the potential costs of regulatory accumulation, the many forms of which Mandel and Carew define.[62] One type of regulatory accumulation is the interaction between regulations, in which "multiple regulations can interact in obvious or non-obvious ways that raise costs for businesses."[63] For example, there is a high likelihood of interaction between the proposed securities lending rule and the short selling rule. In the proposed securities lending rule, the Commission makes only a brief mention of the potential indirect cost on short selling that could result from granular disclosure in the securities lending market. The Commission acknowledges that the proposal "would provide information that may provide a more timely view into short selling

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[57] *See* Proposing Release.
[58] *See* Proposing Release on Short Position and Short Activity Reporting.
[59] *See* "Proposed Rules: Prohibition Against Fraud, Manipulation, or Deception in Connection with Security-Based Swaps; Prohibition against Undue Influence over Chief Compliance Officers; Position Reporting of Large Security-Based Swap Positions," *SEC*, Release No. 34-93784, February 25, 2022.
[60] *See* "Proposed Rule: Modernization of Beneficial Ownership Reporting," Release Nos. 33-11030 and 34-94211, *SEC,* February 10, 2022; "Proposed Rule: Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers," Release No. IA-5950, *SEC,* January 26, 2022.
[61] *See* "Proposed Rule: Private Fund Advisors; Documentation of Registered Investment Adviser Compliance Reviews," Release No. IA-5955, *SEC,* February 9, 2022.
[62] Michael Mandel and Diana G. Carew, "Regulatory Improvement Commission: A Politically-Viable Approach to U.S. Regulatory Reform," *Progressive Policy Institute*, May 2013 ("Mandel and Carew (2013)"), pp. 1–3.
[63] Mandel and Carew (2013), p. 3.

activity than currently exists" and that this may "make it more costly for short sellers to implement their positions as other market participants would more quickly learn about and react to short sellers' activities."[64] In this proposal, however, the Commission does not make a meaningful attempt to estimate how these "dynamics decrease the profitability of short selling and may mitigate some of [the proposed rule's] benefits."[65]

32. The potential indirect effects on the short selling market, and thus on price discovery, of the securities lending rule substantially overlap with the concerns raised in the proposed short selling rule. Under the short selling rule, "institutional investment managers that meet or exceed a specified reporting threshold would be required to report, on a monthly basis[,] …specified short position data and short activity data for equity securities."[66] In that proposal, the Commission considers the potential negative effects that "[p]ublicly releasing aggregated information about large short positions"[67] could have on the short selling market, such as facilitating "potentially manipulative strategies, such as certain short squeezes."[68, 69] The proposing release for the short selling rule also considers investors' desire to protect proprietary trading strategies, as in the proposing release for the securities lending rule. The Commission states that investment managers "seek to trade in ways that would not expose their strategies" and that "other traders could use copycat trading strategies [to] try to mimic the Managers' strategy, potentially competing away the profitability of the strategy."[70]

33. Further, by only considering these rules in isolation, the Commission is not providing a comprehensive picture of the compliance and other direct costs. These costs will aggregate and will burden market participants with higher costs when considered jointly. For example, the securities lending rule estimates that direct compliance with the rule will have an initial cost of $375 million and total annual costs of $140 million that will be imposed on 409

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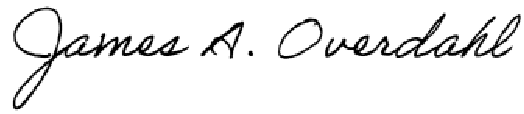
[64] Proposing Release, p. 138.
[65] Proposing Release, p. 138.
[66] Proposing Release on Short Position and Short Activity Reporting, p. 1.
[67] Proposing Release on Short Position and Short Activity Reporting, p. 132.
[68] Proposing Release on Short Position and Short Activity Reporting, p. 127.
[69] Other regulators have acknowledged similar concerns about disclosure providing other market participants with knowledge about an investor's trading. For example, when the CFTC "adopted the Block Trade Rule in 2013, the Commission understood that …the publication of detailed information about an outsize swap transaction could alert the market to the possibility that the original liquidity provider …will be reentering the market to offset that transaction" and that other market participants "would have a strong incentive to exact a premium from the liquidity provider when the liquidity provider seeks to enter into offsetting trades to hedge this risk." They similarly conclude that "[a]s a result, liquidity providers may be deterred from becoming counterparties to outsize swap transactions if swap transaction and pricing data is publicly disseminated before liquidity providers can adequately offset their positions." *See* Federal Register 85, no. 228, November 25, 2020, p. 75442.
[70] Proposing Release on Short Position and Short Activity Reporting, p. 125.

lending and reporting agents.[71] Separately, for the short selling rule, the Commission estimates approximately $50 million to $150 million in direct compliance costs.[72] These costs must be considered jointly and in the context of the direct costs of the other proposed rules.

Respectfully submitted,



James A. Overdahl, Ph.D.

April 1, 2022

[71] Proposing Release, p. 142.

[72] Proposing Release on Short Position and Short Activity Reporting, p. 148.