MANAGED FUNDS ASSOCIATION

February 12, 2007

VIA ELECTRONIC MAIL: rule-comments@sec.gov

Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Attention: Nancy M. Morris, Secretary

Re: SEC Proposal to amend Rule 105 of Regulation M
File No. S7-20-06; Release No. 34-54888 (December 6, 2006)

Ladies and Gentlemen:

The Managed Funds Association (MFA) appreciates this opportunity to comment on the Commission's proposals to amend Rule 105 of Regulation M (Rule 105) discussed in the above release.[1] As representatives of a significant segment of the "buy-side" investor community, we believe that our perspective may provide the Commission with valuable insights into the potential impact of the proposals. We also believe that an examination of the operation of Rule 105 is timely.

Managed Funds Association ("MFA") is the only U.S.-based global membership organization dedicated to serving the needs of those professionals throughout the world who specialize in the alternative investment industry, including hedge funds, commodity pool operators, funds of funds and managed futures funds. MFA's over 1,200 members include professionals from the majority of the 50 largest hedge funds, which manage a significant portion of the estimated $1.3 trillion in assets under management currently invested with hedge funds.

The Commission's objective in proposing changes to Rule 105 of Regulation M is to "further safeguard the integrity of the capital raising process and protect issuers from manipulative activity that can reduce issuers' offering proceeds and dilute shareholder value." A related objective is to provide a "bright-line test for Rule 105 compliance consistent with the prophylactic nature of Regulation M." MFA believes that enhancing the capital raising process and facilitating compliance with SEC rules are desirable goals. In our view, however, the proposals in their present form do not further these objectives well. We offer our comments on the proposals below, and would be pleased to meet with the Commissioners or Staff to discuss our views if that would be of assistance.

---

[1] 71 FR 75002 (Release).

Preliminarily, we note that the Release asks numerous questions about the present operation of the rule and other possible changes that could be made. While we offer our views on some of the questions below, we believe that no substantive changes discussed but not specifically proposed in the Release should be made to the Rule unless each change has been the subject of specific notice and comment. We believe that many of the questions concern changes that would affect trading and market practices with significant economic consequences. We would happy to assist the Commission in exploring this broader range of issues.

A. General

1. The proposed changes dramatically change the nature of the rule.

(a) The proposal would create a new status-type limitation

MFA believes that the proposed changes represent a radical change in the Commission's approach to the perceived problem of manipulative short selling prior to the pricing of a public offering.[2] The present rule requires a purposeful connection between a short sale and a purchase in the offering. This is reflected in the use of the term "covering" in the rule. A *short sale* is "tainted" only where a short seller purchases securities from an underwriter or broker or dealer participating in a firm commitment offering and *covers* a short sale made by that person during the five business day restricted period before pricing of the offering. The proposed rule changes, in contrast, would taint the *person* who sold short during the restricted period (and perhaps others who effected the trade, as we discuss below). That person would be prohibited from purchasing in the offering. This would be the case even if the person could prove that he did not have (or could not have had) any knowledge of the offering at the time of the short sale, or could clearly show that the shares purchased in the offering did not cover any short sale made during the restricted period.

The draconian nature of the status-type limitation proposed for Rule 105 is also revealed by the fact that even a short sale during the restricted period that had *no* demonstrable impact on a security's market price would preclude the short seller from purchasing shares in an offering of that security. For example, the proposal makes no exceptions for short sales effected on upticks (for example, to comply with present Rule 10a-1(a)), or on a de minimis downtick that can occur in a decimals trading environment. This stands in stark contrast to the action that the Commission proposes to take with respect to Rule 10a-1, another prophylactic short sale rule.[3]

---

[2] The Commission has stated that the provisions of Regulation M do not require a showing of intent to manipulate. See, e.g., Release 34-33-8511 (Dec. 9, 2004), 69 FR 75774, 75775 (proposing amendments to Regulation M); see also Release 33-6798 (Aug. 25, 1988), 53 FR 33455, 33456 (adoption of temporary Rule 10b-21(T)). However, Rule 105 requires a showing that the shares purchased in an offering were used to cover a short sale effected during the rule's restricted period.

[3] See Release 34-54891 (Dec. 7, 2006), 71 FR 75068 (Rule 10a-1 Proposing Release). "[I]n a decimals environment, the tick test of Rule 10a-1 may be triggered by a change in price that reflects an extremely small decrease

In summary, whereas today the Rule requires some purposeful connection between the short sale and the purchase in the offering (i.e., "covering"), the proposal would create a status-type limitation and prohibit any purchase of offering shares, even if the purchases can be shown to be unrelated to the short sale.

(b) The proposed rule is an absolute prohibition

The proposed rule would be a prophylactic prohibition similar to other provisions of Regulation M.[4] However, unlike the other provisions, Rule 105 would be an absolute prohibition. For example, a person that sold even one share short during the restricted period would be prohibited from purchasing any shares in a firm commitment offering of that security. This should be contrasted with Rule 101(b)(7) of Regulation M which excuses de minimis transactions from the general prohibition of Rule 101.[5]

More generally, the Rule 105 proposal takes a more sweeping anti-manipulation approach than does Rule 101 of Regulation M. With regard to the latter, the Commission determined that "actively-traded securities" need not be subject to prophylactic restrictions, because these securities have high levels of trade transparency and surveillance by market regulators.[6] There is no analogous exception in Rule 105. Similarly, there is no exception for investment grade debt securities in Rule 105 as there is in Rule 101.[7]

We respectfully submit that, if the Commission determines to adopt the type of prophylactic prohibition contained in the proposal, it should include exceptions for transactions and securities consistent with the analogous prophylactic provisions of Regulation M.[8]

---

in the price of the security. We do not believe that a price change as small as one penny per share results in the type of market impact that Rule 10a-1 was designed to prevent." 71 FR at 75076.

[4] The Release states that the proposal "restructures the rule in an effort to promote compliance with the prophylactic nature of Regulation M." 71 FR at 75005.

[5] See also Rule 101(b)(2) of Regulation M, which excepts transactions in odd lots of the security in distribution.

[6] See Rule 101(c)(1) of Regulation M. "Actively traded securities" are securities that have an average daily trading volume value of at least $1 million and are issued by an issuer whose common equity securities have a public float value of at least $150 million.

[7] See Rule 101(c)(2) of Regulation M.

[8] Moreover, we believe that the Commission's consideration of the proposals should take into account the fact that the Commission has additional tools to redress manipulative activity that affects offering prices. The Preliminary Note to Regulation M, which applies to Rule 105, states: "Any transaction or series of transactions, whether or not effected pursuant to the provisions of Regulation M, remain subject to the antifraud and antimanipulation provisions of the securities laws,…." See also Rule 10a-1 Proposing Release, 71 FR at 75075.

(c) The rule should not be extended to derivatives

The Release asks whether Rule 105 should apply to transactions in derivatives, although there is no specific proposal for rule text.[9] MFA believes that such a change would be another significant departure from the Commission's philosophy underlying Regulation M and the coverage of derivatives in its prophylactic rules. The Release notes that the Commission decided not to "[extend] the rule's prohibitions to derivative securities [because it] would be inconsistent with the approach of Regulation M…."[10] MFA believes that this judgment continues to be correct.

The Release states a concern that derivatives could be used as part of trading strategies designed to *evade* the application of Rule 105, citing the Commission's Married Puts Release.[11] We appreciate the Commission's concerns about evasion of regulatory requirements, but that should not be confused or equated with the potential use of derivatives to *avoid* the restrictions of Rule 105. As indicated by the Commission's contemporaneous release regarding Rule 10a-1, avoidance of prophylactic rule is not prohibited where the conduct is otherwise lawful.[12] Because of the potential impact on many legitimate trading strategies, the potential inclusion of derivative transactions in Rule 105, if pursued, should be proposed for specific analysis and public comment. We recognize that Regulation M, including Rule 105, has been adopted pursuant to a range of statutory authority, but we respectfully submit that a thorough analysis of the statutory authority and the underlying Congressional intent should be undertaken in connection with any proposal to extend Rule 105 to derivative products.[13]

---

[9] 71 FR at 75005-75006.

[10] Id. at 75005.

[11] Id., citing Release 34-48795 (Nov. 17, 2003), 68 FR 65820.

[12] See, e.g., Rule 10a-1 Proposing Release, 71 FR at 75075 (noting that "price test restrictions result in market participants routing orders to avoid application of price test restrictions.…"); see also Letter to The Honorable Karon O. Bowdre from Jacob H. Stillman, Solicitor, SEC re: In re HealthSouth Securities Litigation (Nov. 28, 2006) at 9 ("there is nothing inherently nefarious about seeking to avoid Commission review or the possibility of [Securities Act] liability.")

[13] For example, the Commission's plenary authority to adopt rules and regulations with respect to short sales of exchange-registered securities does not extend to a type of derivative that may be most relevant in considering short selling restrictions, namely securities futures products. See Exchange Act Section 10(a)(2); Release 34-48709 (Oct. 28, 2003), 68 FR 62972, 62983 ("Congress exempted transactions in security futures products from short sale regulation. Short security futures…may function as a substitute for short selling the underlying stock.").

2. *The proposed changes would be counterproductive in relation to the Commission's objectives.*

While the Commission's stated objective of protecting the integrity of the capital raising process for public offerings is important, the proposed rule changes might have the opposite effect. Investors, such as hedge funds, would be forced to make a choice between selling a security short during the restricted period and purchasing that security in an offering. In some cases, there may not even be an element of choice, because the offering period prior to pricing may be shorter than the five day restricted period, and an investor may already have sold the security short before the offering is announced (the so-called "gotcha" situation). We believe that a variety of Commission rules focus on structural separation or the knowledge (or lack of knowledge) of the individual trader rather than the firm as a whole in determining the applicability of restrictions.[14] Even after announcement of an offering, a firm pursuing multiple trading strategies may have to suspend all short selling in order not to be disqualified from purchasing in the offering. This could impair trading strategies in which the issuer's fundamentals or current market price are completely irrelevant, such as statistical arbitrage and convertible arbitrage, as we note below. Such a firm may have no choice but to forgo the opportunity to purchase in an offering rather than disrupt the operation of its complex trading strategies. The proposal does not address these problems.[15]

Hedge funds and other active traders are significant purchasers in securities offerings. By effectively forcing such potential purchasers out of the secondary offering market, the supply/demand ratio will be skewed, with likely negative consequences for capital raising. This is the opposite result from the Commission's goal in proposing changes to Rule 105. We again offer our assistance to the Commission to address these issues.

3. *A timely opportunity*

MFA believes that the present rulemaking exercise presents a timely opportunity for the Commission to thoroughly examine the operation of Rule 105. We submit that Rule 105, and particularly as it is proposed to be amended, does not adequately reflect the Commission's oft-repeated statements about the benefits that short selling provides to the markets.[16] Instead, the Commission has stated: "The reason for the prohibition [in Rule 105] is that pre-pricing short sales that are covered with offering shares artificially distort the market price for the security…."[17] MFA believes that this Commission statement does not adequately recognize, as other Commission rules and statements do, that not all short sales, including many made during

[14] See, e.g., Rule 100(b)(3) of Regulation M; Exchange Rule 14e-3(b).

[15] This problem would be ameliorated if non-broker-dealers were permitted to use aggregation units, as we discuss below.

[16] See, e.g., Rule 10a-1 Proposing Release, 71 FR at 75069-75070.

[17] Release 34-50103 (July 28, 2004), 69 FR 48008, 48020 (Regulation SHO Adopting Release).

the Rule 105 restricted period, have a distorting effect on a security's market price, or that in many cases where the market price is affected by a short sale, the transaction was not undertaken for that purpose. We provide two examples of how an overly narrow view of short selling is reflected in the Rule 105 proposal.

Arbitrage. Rule 10a-1, another prophylactic short selling provision, explicitly recognizes the beneficial role of arbitrage in the securities markets by including exceptions from its price test for bona fide arbitrage transactions involving short sales of securities.[18] No arbitrage exception is included in, or proposed for, Rule 105. MFA believes that the Commission should consider the necessity and appropriateness of such an exception in Rule 105.

Hedging. The Commission has recognized that "short selling is integral to many complex trading strategies involving a variety of sophisticated financial instruments. Short sales are often used in these strategies to hedge a position in another security or related financial instrument."[19] Bona fide hedging transactions are not undertaken to influence a security's price, although some hedging short sales can have that effect. However, Rule 105 does not incorporate this market reality. MFA believes that the Commission should evaluate the necessity and appropriateness of an exception for bona fide hedging short sales in Rule 105.

We also note that, at the time that it adopted the predecessor of Rule 105, the Commission's Staff prepared a statistical analysis of the impact of the rule (which had been adopted on a temporary basis) on stock price patterns around the time of offerings.[20] Although the Staff's analysis found no statistical evidence of a price impact, the Commission determined to adopt the rule on a permanent basis. We suggest that the time is ripe for the Staff to conduct another quantitative analysis of the impact of Rule 105 before additional changes are made.[21]

---

[18] See 17 CFR 240.10a-1(e)(7) and (8).

[19] Release 34-42037 (Oct. 21, 1999), 68 FR 57996, 58000 (concept release on short selling).

[20] Release 34-33702 (March 2, 1994), 59 FR 10984 (Rule 10b-21 Adopting Release).

[21] An empirical study also would be consistent with the approach that the Commission took in connection with its proposal regarding Rule 10a-1. Rule 10a-1 Proposing Release, 71 FR at 75072-75075 (discussing the Regulation SHO Pilot). The Release asks questions about some empirical evidence of security price declines in advance of secondary offerings. 71 FR at 75007. Without knowing the scope and parameters of the data in the study, however, it is not possible to evaluate whether Rule 105 as presently constituted, or as proposed to be amended, has any relationship to the price changes described. We also note that empirical studies showed similar price movements both before and after the adoption of the predecessor to Rule 105. Id. n.39.

B. Rule text

1. *The proposal does not provide a bright line test, and introduces greater uncertainty about the prohibited conduct.*

One stated objective of the proposed changes to the rule text is to provide a bright line: if a person sells a security short within the five business days before pricing of a firm commitment offering of such security, then that person may not purchase shares in the offering. Assuming that such a change is warranted, only a few changes to the present rule appear to be necessary. However, the proposal makes numerous changes to the rule text and introduces terms that are not discussed or explained in the release. The result is that, rather than clearly identifying the prohibited conduct, the proposed rule injects substantial uncertainty and will make it even more difficult for market participants to fashion compliance programs. We discuss the most significant changes below.

"Effects." The release incorrectly implies that the proposed rule would have the same coverage as the present rule.[22] The proposed rule, however, would no longer apply to a person who *covers* a short sale. It would apply to any person who *effects* a short sale. We understand that the term "effects" has been interpreted very broadly by the SEC and the Staff. However, there is no discussion in the release about the use of this term in the proposed rule.[23] With this change, the focus of the proposal would no longer be on short selling *and* covering activity, but rather only on short selling activity. As discussed above, the proposal would create a status limitation and prohibit purchases that are completely unrelated to a particular short sale.

"Contract of Sale." Additional uncertainty would result from the proposed insertion of this phrase in the rule, which also appears throughout the Release but is not explained. On one level, it appears to show the new focus of the rule on short *selling* rather than purchasing offering shares (i.e., "covering"). However, inclusion of that phrase appears to be unnecessary, because Section 3(a)(14) of the Exchange Act defines "sale" to include "contract to sell." On the other hand, this may be a mistaken choice of terms. The Release states: "As with current Rule 105, responsibility for compliance with the proposal would rest with the person that effects a short sale during the restricted period *and purchases, including entering into a contract of sale for, the security in the offering allocation."* [24] This suggests that the focus would continue

---

[22] 71 FR at 75005.

[23] By proposing to apply the rule to any person that effects a short sale, the proposal could cover a broker-dealer that executes a short sale for any account. That could include the underwriters and selling group members of an offering: if one of those brokers effected a short sale for a customer in the five business days before pricing, that broker could be precluded from purchasing offering shares for its own account. This means, for example, that an underwriter that effected a short sale for a customer might be precluded from purchasing for its investment account to close a sticky offering. We doubt that the Commission intends the rule to apply in these ways.

[24] 71 FR at 75005.

to be on purchasing in the offering. If so, the appropriate term would be "contract to purchase." Here again, however, inclusion of that term would be unnecessary, because a contract to purchase is included in the term "purchase" in Exchange Act Section 3(a)(13). We submit that the proposed new phrase either is unnecessary or should be explained clearly.[25]

"Security in the offering." The Commission proposes to use the phrase "the security in the offering." This phrase would create interpretive and compliance difficulties. For example, the Rule is proposed to read: "it shall be unlawful to effect a short sale… and then purchase… the security in the offering…." This is ambiguous.[26] It could suggest that the short sale and the purchase involve the offered security. However, the Commission repeatedly has taken the position that a person cannot sell short the offered security before the effectiveness of the registration statement for the offering, because such a sale would be a violation of Section 5 of the Securities Act of 1933.[27] Or, it could mean "the security that is the subject of the offering." However, that would appear to prohibit even market purchases of a security if a short sale of the security has been made during the restricted period before an offering of that security, which the rule is not intended to do.

The purpose of this phrase is probably to capture a purchase (but not the short sale) "of the offered security." This is clearer in the present rule, because the short seller is prohibited from purchasing offered securities *"from an underwriter or broker or dealer participating in the offering,"* but this text is deleted from the proposed rule (again, without discussion). Moreover, by using the proposed ambiguous language and deleting this text, the Commission may be reintroducing an earlier concern that the present rule text was intended to address. When Rule 10b-21 (the predecessor to Rule 105) was proposed, there was a concern that a person who purchased shares for an investor or broker who had purchased shares in the offering (but was not participating in the underwriting syndicate, and with whom the person did not have a prearrangement to obtain the shares) would be captured by the rule. So the italicized phrase was included to limit the scope of purchases that the rule was intended to cover.[28]

---

[25] Use of the terms "contract to purchase" or "contract to sell" could be read to incorporate transactions in derivatives in the rule. However, as discussed above, the Commission explicitly declined to extend the prohibitions of Regulation M to derivative products, with the apparent exception of security futures. See Release 33-8107 (June 21, 2002), 67 FR 43234, 43243, Questions and Answers 33-36. Another possibility for the use of these terms is that they are intended to capture indirect methods of selling (or purchasing). However, as the Release notes, activity that accomplishes indirectly what is directly proscribed is also prohibited. 71 FR at 75006.

[26] A similar ambiguity arises in connection with the proposed phrase "in the offered security."

[27] See e.g., SEC v. Edwin Buchanan Lyon, IV, SEC Litigation Release No. 19942 (Dec. 12, 2006); SEC v. Langley Partners, L.P., SEC Litigation Release No. 19607 (Mar. 14, 2006).

[28] See Release 33-6798 (Aug. 25, 1988), 53 FR 33455, 33457-33458 (Temporary Rule 10b-21 Adopting Release).

C. Other Comments

1. *"Tainting" of earlier short sales and "neutralizing" restricted period short sales*

The Commission in effect asks whether a person who sells short during the restricted period should be able to "neutralize" the market impact of the short sale by purchasing the same security in the market before pricing of the offering.[29] The Release also asks whether the short seller should be required to close-out its *entire* short position, or only the short sales made during the restricted period. The Commission here appears to be implicitly incorporating a Staff interpretation that a short sale made during the restricted period precludes the seller from purchasing in the offering to cover *any* outstanding short position.[30] Under that interpretation, *all* of the short seller's short positions, even those created months before the restricted period, are "tainted."

MFA believes that a trader should have the option of "neutralizing" a restricted period short sale by purchasing shares in the market before the offering is priced. The focus of Rule 105 is a manipulative bear-raid on a security before pricing of an offering. As such, the rule should be precisely tailored to recognize that a market participant whose trading is net flat or net long during the restricted period is not likely to have any manipulative intent or impact on the market for the security. Therefore, if the Commission determines to adopt a prophylactic rule similar to the proposal, we suggest that the rule be refashioned to focus on whether a person's trading is net short, rather than whether a person has effected any short sales. As such, an investor who sells short a small amount during the restricted period, may decide to purchase an amount of shares equal to the short sale during the restricted period, and avoid the prohibition against purchasing in the offering.[31]

The Release suggests that if this type of relief were available, the trader would need to evidence the market purchases using *required* books and records.[32] This could imply that the relief is limited to entities registered with the Commission or who are otherwise required to maintain transaction records. We request that the Commission clarify that the records of a

---

[29] 71 FR at 75007.

[30] See SEC Division of Market Regulation, Staff Legal Bulletin No. 9 (rev. April 12, 2002). In a sense, this Staff interpretation presages the current rule proposal which, as we discuss above, "taints" the short seller (*i.e.*, *all* of the short seller's positions) rather than only the short sales made by that person during the five day restricted period.

[31] The trader should have the benefit of this relief irrespective of whether the market purchase of the shares during the restricted period preceded or followed the short sale. Apart from the "neutralizing" situation, if the rule is adopted along the lines as proposed, the Staff's interpretation would be moot, because a person who sold short during the restricted period would be prohibited from purchasing any securities from the offering.

[32] 71 FR at 71006.

trader's account maintained by such an entity also would satisfy this requirement. We believe, however, that the limitation to required records is too restrictive. A trader should be able to use any bona fide records to evidence its market purchases. If necessary, the Commission could specify what, if any, records in addition to the records of broker-dealers that effect its transactions a trader must have in order to rely on this provision.

2. *Aggregation units.*

Rule 200(f) of Regulation SHO permits broker-dealers to create independent trading units that can aggregate their security positions separately from other aggregation units in determining their net positions for short sale purposes.[33] The Release proposes to expand the availability of aggregation units beyond broker-dealers, but implies that it would be available only to *registered* entities (or clients of registered entities).[34] MFA believes that expansion is appropriate, but that Rule 200(f) should extend beyond registered entities. Firms with similar structures and needs should be able to use aggregation units. The multiple strategies pursued by mutual funds, pension plans, hedge funds, and others (in addition to broker-dealers) may make it impracticable to know real-time positions on a firm-wide basis.[35] For example, sharing of position information could be detrimental to compliance with some laws (e.g., insider trading prohibitions) or conflict with fiduciary responsibilities. Moreover, as noted above, many of these trading strategies are unrelated to the fundamentals of an issuer or the fact that there is a prospective offering of an issuer's securities. If a firm cannot use aggregation units to manage its short selling activity, it may have no choice but to continue its trading and forego the opportunity to invest in offerings. As discussed above, we believe that that result would have detrimental effects on offerings.

At the very least, we believe that the availability of aggregation units should be extended to registered investment advisers. These entities like broker-dealers are already accustomed to the requirements of registration and subject to routine examinations. As such, registered investment advisers would transition easily into a similar aggregation unit framework as broker-dealers.

This is a topic of particular importance to MFA members. We believe that competitive realities and market developments warrant a re-examination by the Commission of

---

[33] Implicit in the discussion in the release about Rule 200(f) is the principle that aggregation units are effective not only for Regulation SHO, but also for Rule 105.

[34] 71 FR at 75007.

[35] The Regulation SHO Adopting Release suggests that the Commission expects that firms will aggregate their positions on a firm-wide real-time basis. 69 FR at 48010-48011 n.24. That footnote, however, also indicates that the Commission allows for alternative aggregation methods where real-time aggregation is impracticable.

extending aggregation unit availability in Rule 200(f) beyond its present scope.[36] The significant issues related to this topic should be aired in a separate proceeding to allow focussed Commission analysis and comment by all affected participants.[37]

3. *PIPEs*.

The release asks whether the rule should address short sales "effected during the period following the entering into a PIPE transaction."[38] MFA believes that such a change would represent an unwarranted expansion of Rule 105, and in general would serve no useful purpose. Moreover, extension of Rule 105 to PIPE transaction, particularly as the rule is proposed to be amended, could have significant adverse economic consequences for capital raising.

In the typical PIPE transaction, a private placement of shares by an issuer is followed by a registered offering to allow the private placement purchasers (PPPs) to sell their shares in the public market. Until the registration for the secondary offering becomes effective, the PPPs hold restricted securities. Frequently, the PPPs will seek to hedge their economic risk in holding the restricted shares; often this is done by selling freely-trading shares short in the market. As the Commission has noted in a number of recent Enforcement actions that short selling to hedge a restricted stock position can be done in a manner that complies with regulatory requirements.[39] Unfortunately, however, the Commission has provided little guidance as to its views of how this may be done. Moreover, the summary nature of other consent orders does not provide much explanation of how the firms in question unwound their short positions in a way that resulted in charges of violating Rule 105.[40] We respectfully suggest that additional detail in Enforcement orders would assist our members in developing policies and procedures to achieve compliance with regulatory requirements.

---

[36] Because aggregation units are costly to maintain, they would only be cost-effective if they applied beyond the Rule 105 context, i.e., to all short selling activity.

[37] Rule 200(f) represents the codification of a lengthy process to develop workable parameters for aggregation units for broker-dealers. See Regulation SHO Adopting Release, 69 FR at 48010. We believe that that foundation can be used to broaden the scope of aggregation units, but the process will require consultation with a range of market participants and evaluation of a variety of factors. MFA stands ready to assist in that process.

[38] 71 FR at 75006.

[39] See, e.g., SEC v. Joseph J. Spiegel, (D.D.C., Jan. 2007) (Complaint paragraph 13); SEC v. Edwin Buchanan Lyon, IV, (S.D.N.Y, Dec. 2006) (Complaint paragraphs 22, 24); SEC v. Langley Partners, L.P., (D.D.C., Mar. 2006) (Complaint paragraphs 15, 17).

[40] See, e.g, SEC v. Solar Group S.A., (S.D.N.Y., Nov. 2006); SEC v. Graycort Financial, LLC, (N.D. Cal., Sept. 2006). See also Citigroup Global Markets, Inc., NYSE Hearing Board Decision 06-111 (June 2006) (consent finding that firm lacked sufficient policies and procedures to prevent violations of Rule 105).

An extension of Rule 105 to these short sales would effectively preclude the PPPs from hedging their positions. PPPs may not want to run the risk that the Commission would claim that their market purchases to cover their short positions near the time of effectiveness of the registration statement for the PIPE offering were a "sham" and therefore the PPP violated Rule 105 (and possibly Section 5).[41] This could make PIPES uneconomic for such investors, or it could require a much larger discount to allow the issuer to sell the private placement. If fewer investors are willing to participate in a PIPE offering, the price and consequently the proceeds are likely to be lower, with negative results for the issuer and underwriters. This reduction in offering proceeds to the issuer is precisely the type of result that the SEC says Rule 105 is designed to prevent.

Moreover, we believe that the application of Rule 105 to PIPES would not further the Commission's objectives. In a PIPE, the issuer has sold its securities for a stated consideration when the private placement is completed. The subsequent registered offering is a secondary sale of the PPPs' securities. Short sales by the PPPs shortly before pricing of the secondary offering would tend to lower the potential proceeds from the sale of their shares, and therefore would be against their own interests. It is also important to note that typically short sales to hedge a position in restricted PIPE shares occur well in advance of the public offering and should have very little, if any, impact on the pricing of the offered shares. Expansion of the Rule to cover these short sales would therefore serve little regulatory purpose, but would constitute a significant expansion of the prohibitory period in the rule.[42]

* * * * *

(Continued on page 13.)

[41] See, e.g., Regulation SHO Adopting Release, 69 FR at 48020-48021.

[42] The Release specifically asks about convertible debenture PIPEs. 71 FR at 75006. This type of security, also called a "floorless convertible," contains a formula whereby the holder of the convertible receives a greater number of shares upon conversion as the price of the security declines. This type of security is used in a small percentage of PIPE deals. This type of security has been involved in Commission enforcement actions alleging manipulative short selling to lower the security's price in order to increase the number of shares upon conversion. See, e.g., SEC v. Andreas Badian, SEC Litigation Release No. 19639 (Apr. 4, 2006). However, extending the rule to cover these securities would stretch it in a manner far beyond its present scope: the conversion feature of a security is not a fixed price offering, and the securities obtained upon conversion are not purchased from a broker-dealer participating in an offering (although, as discussed above, the Commission proposes to delete that element of the present rule).

Conclusion

MFA appreciates the opportunity to comment on the Commission's proposal to amend Rule 105. As discussed above, we believe that the rule as proposed may not achieve, and in fact may be contrary to, the Commission's investor and market protection goals. Moreover, the proposed rule would present significant interpretive and compliance difficulties for market participants, especially active traders. We would be pleased to meet with Commissioners or Staff to discuss our comments.

Respectfully submitted,

John G. Gaine
President

Cc: The Hon. Christopher Cox, Chairman
The Hon. Paul S. Atkins Commissioner
The Hon. Roel C. Campos
The Hon. Annette L. Nazareth
The Hon. Kathleen L. Casey
Erik R. Sirri, Director
Division of Market Regulation
Robert L. D. Colby, Deputy Director
Division of Market Regulation
James A Brigagliano, Associate Director
Division of Market Regulation
Chester Spatt, Chief Economist
Brian G. Cartwright, General Counsel