December 16, 2008

***Via Electronic Delivery and Hand Delivery***

The Honorable Christopher Cox
Chairman
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: File No. S7-30-08; Rel. No. 34-58773
Amendments to Regulation SHO

File No. S7-31-08; Rel. No. 34-58785
Disclosure of Short Sales and Short Positions by
Institutional Investment Managers

Dear Chairman Cox:

The Coalition of Private Investment Companies ("CPIC")[1] is pleased to submit its comments regarding the above-referenced Interim Final Temporary Rules of the Securities and Exchange Commission ("SEC" or "Commission"). On behalf of our members, we appreciate the opportunity to provide our views on these rules. We also wish to take this opportunity to comment more broadly on the Commission's recent actions relating to the regulation of short sale practices.

Following a series of Commission Emergency Orders related to short selling (discussed below) and Congress's passage of the Emergency Economic Stabilization Act of 2008 ("EESA"),[2] the Commission has adopted and requested public comment on two temporary interim final rules. The first interim final temporary rule, Rule 204T of Regulation SHO under the Securities Exchange Act of 1934 ("Exchange Act"),[3] requires participants of a registered clearing agency to deliver securities on a long or short sale in any equity security by settlement date and promptly close out any failures to deliver, and imposes penalty conditions on short sales in a security where the close out requirement has not been met.[4] Rule 204T is effective until

[1] CPIC is a coalition of over 20 private investment companies whose members and associates manage or advise over $75 billion in assets. CPIC's members are diverse in size and in the investment strategies they pursue. CPIC was established in 2005 in order to inform policy-makers, the media and the public about the private fund industry and its role in the capital markets.

[2] Emergency Economic Stabilization, Pub. L. 110-343 (2008).

[3] 17 C.F.R. § 242.204T (2008).

[4] Amendments to Regulation SHO, Release No. 34-58773 (Oct. 14, 2008), 73 Fed. Reg. 61706 (Oct. 17, 2008).

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July 31, 2009. The second interim final temporary rule, Exchange Act Rule 10a-3T,[5] requires certain institutional investment managers to file with the Commission information on temporary Form SH concerning their short sales and short positions in Section 13(f) securities, other than options.[6] Rule 10A-3T is effective until August 1, 2009. CPIC supports Rule 204T and supports providing the Commission with information regarding short sale activity, which is the goal of Rule 10a-3T, subject to our further comments on the two rules below.

We also support the conclusions reached by the Commission that led to the elimination of the options market-maker exception to the close out requirements of Regulation SHO. We believe the Commission's decision had enhanced credibility because it was adopted after providing notice and opportunity for comment and a thorough review of relevant market data.[7] In addition, we support the Commission's recent adoption of Exchange Act Rule 10b-21,[8] making it unlawful for any person to deceive a broker-dealer, participant of a registered clearing agency or purchaser regarding that person's intent or ability to deliver an equity security on or before the settlement date -- a rule that also was adopted pursuant to notice and comment rulemaking.[9] We urge the Commission to vigorously enforce this rule and its other antifraud rules designed to protect investors and curb market abuses.

However, in contrast to the open and deliberative process that yielded the sound policy decisions described above, the approach taken by the Commission in a series of "Emergency Orders" that imposed conditions upon, and then banned, short sales in certain securities is a cause for serious concern. The first of these orders imposed conditions on short sales in the

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[5] 17 C.F.R. § 240.10a-3T (2008).

[6] Disclosure of Short Sales and Short Positions by Institutional Investment Managers, Release No. 34-58785 (Oct. 15, 2008), 73 Fed. Reg. 61678 (Oct. 17, 2008). The filing requirement applies to any institutional investment manager that exercises investment discretion with respect to accounts holding Section 13(f) securities that has filed, or was required to file, a Form 13F for the prior calendar quarter and whose short sales meet certain thresholds.

[7] Eliminating or narrowing the exception was the subject of a series of carefully considered SEC notices soliciting comment rulemaking between 2006 and 2008. *See, e.g.*, Amendments to Regulation SHO, Release No. 34-54154 (Jul. 14, 2006), 71 Fed. Reg. 41710 (July 21, 2006); Amendments to Regulation SHO, Release No. 34-55520 (Mar. 26, 2007), 72 Fed. Reg. 15079 (Mar. 30, 2007); Amendments to Regulation SHO, Release No. 34-56213 (Aug. 7, 2007), 72 Fed. Reg. 45558 (Aug. 14, 2007); Amendments to Regulation SHO, Release No. 34-58107 (July 7, 2008), 73 Fed. Reg. 40201 (July 14, 2008); Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Release No. 34-58572 (Sept. 17, 2008), 73 Fed. Reg. 54875 (Sept. 23, 2008); Amendments to Regulation SHO, Release No. 34-58775 (Oct. 14, 2008), 73 Fed. Reg. 61690 (Oct. 17, 2008).

[8] 17 C.F.R. § 240.10b-21 (2008).

[9] *See* "Naked" Short Selling Antifraud Rule, Release No. 34-58774 (Oct. 14, 2008), 73 Fed. Reg. 61666 (Oct. 17, 2008). *See also* "Naked" Short Selling Antifraud Rule, Release No. 34-57511 (Mar. 17, 2008), 73 Fed. Reg. 15376 (Mar. 21, 2008); Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Release No. 34-58572 (Sept. 17, 2008), 73 Fed. Reg. 54875 (Sept. 23, 2008).

securities of two Government-Sponsored Enterprises and 17 commercial and investment banks,[10] while the second imposed a complete ban on short sales of an expanding list of "financial" stocks.[11] Simply, the Commission lacked the requisite basis to eliminate the safeguards against arbitrary government intervention, and thus the impartiality of the Commission was needlessly compromised. Over many years and in many economic and global crises, the Commission has maintained a dispassionate and objective view of short selling activity, acknowledging its significant benefits to market liquidity and pricing efficiency,[12] and regulating it with measured

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[10] *See* Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Release No. 34-58166 (July 15, 2008) (effective from July 21, 2008 through July 29, 2008), 73 Fed. Reg. 42379 (July 21, 2008); Amendment to Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Release No. 34-58190 (July 18, 2008) (amending the July 15th Emergency Order), 73 Fed. Reg. 42837 (July 23, 2008); Order Extending Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Release No. 34-58248 (July 29, 2008) (extending the July 15th Emergency Order to August 12, 2008), 73 Fed. Reg. 45257 (Aug. 4, 2008). The 17 commercial and investment banks were primary dealers -- firms that trade government securities directly with the Federal Reserve System.

[11] Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Release No. 34-58592 (Sept. 18, 2008), 73 Fed. Reg. 55169 (Sept. 24, 2008). The ban was amended to give the national securities exchanges authority to select individual financial institutions with equity securities covered by the ban. Amendment to Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Release No. 34-58611 (Sept. 21, 2008), 73 Fed. Reg. 55556 (Sept. 25, 2008). On October 2, 2008, the ban was extended so that it would terminate at the earlier of three business days from the President's signing of the EESA or October 17, 2008. Order Extending Emergency Order Halting Short Selling in Financial Stocks, Release No. 34-58723 (Oct. 2, 2008), 73 Fed. Reg. 58994 (Oct. 8, 2008). On October 3, 2008, the President signed EESA (H.R. 1424) and the short sale ban expired on October 8, 2008.

[12] *See* Concept Release: Short Sales, Release No. 34-42037 (Oct. 20, 1999), 64 Fed. Reg. 57996 (Oct. 28, 1999), in which the Commission stated:

> Short selling provides the market with two important benefits: market liquidity and pricing efficiency. Substantial market liquidity is provided through short selling by market professionals . . . who facilitate the operation of the markets by offsetting temporary imbalances in the supply and demand for securities . . . [S]uch short sale activities, in effect, add to the trading supply of stock available to purchasers and reduce the risk that the price paid by investors is artificially high because of a temporary contraction of supply.
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> Short selling also can contribute to the pricing efficiency of the equities markets. Efficient markets require that prices fully reflect all buy and sell interest. . . . [S]hort sellers add to stock pricing efficiency because their transactions inform the market of their evaluation of future stock price performance. This evaluation is reflected in the resulting market price of the security.

64 Fed. Reg. at 57997.

In an interview in July, Chairman Cox also noted that legitimate short selling provides market liquidity and contributes to price discovery, and is important to a well functioning market by preventing market bubbles. *See*

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rules, adopted after substantial consideration and public comment.[13] In the past, when corporate executives have attacked short sellers who have raised questions about a company's flawed business plans or potentially fraudulent financial reports, the Commission has pointed to the substantial evidence that often it is the short sellers that have been right about a company's prospects, and it is company management that has misled the public.[14] A ban on short selling -- as the Commission instituted in September for almost 1000 issuers -- is tantamount to "blaming the shorts," suggesting the Commission's support for the view promoted by CEOs of troubled financial institutions that short sellers were somehow responsible for their problems. It is readily apparent, however, that recent declines in the share prices of financial issuers are properly attributed to a devastating combination of lax lending standards in residential real estate, deficient underwriting practices in mortgages and in mortgage-backed securities, poor performance by credit rating agencies, overleveraged banks, unrestrained speculation in opaque over-the-counter financial products, lack of effective risk management at financial institutions, and ineffective regulation and oversight -- problems many short sellers were warning about months and even years ago.[15]

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Statement of Christopher Cox, Chairman of the SEC, in a transcript of a CNBC Interview with Erin Burnett, July 16, 2008 (transcript on file with CPIC).

[13] In 2004, the SEC adopted Regulation SHO (17 C.F.R. § 242.200 et seq. (2004)), which is the primary SEC rule addressing short sales. *See* Short Sales, Release No. 34-50103 (July 28, 2004), 69 Fed. Reg. 48008 (Aug. 6, 2004). According to the adopting release, Regulation SHO was adopted after the Commission considered letters from 462 commenters, and upon examination of market practices and the purposes underlying short sale regulation.

[14] For example, in testimony presented to Congress in 1989, the Commission's Associate Director of Enforcement, John Sturc, outlined reasons that the Commission frequently finds that complaints of downward manipulation from issuers or their affiliates do not lead to sustainable evidence of antifraud violations. His joint prepared statement with Richard G. Ketchum, Director, Division of Market Regulation, noted:

> [N]egative statements which persons holding short positions are alleged to have disseminated to the marketplace may be true or may represent expressions of investment opinion by professional securities analysts. . . . *[M]any of the complaints we receive about alleged illegal short selling come from companies and corporate officers who are themselves under investigation by the Commission or others for possible violations of the securities or other laws.*

*Short Selling Activity in the Stock Market: The Effects on Small Companies and the Need for Regulation, Hearing Before the H. Comm. on Gov. Affairs, Subcomm. on Commerce, Consumer, & Monetary Affairs*, 101 Cong. 434-35 (Dec. 6, 1989) (statement of Richard G. Ketchum, Director, Division of Market Regulation and John H. Sturc, Associate Director, Division of Enforcement, Securities and Exchange Commission) (emphasis added).

[15] *See* James Chanos, *Short Sellers Keep the Market Honest*, Wall St. J., Sept. 22, 2008, *available at* http://online.wsj.com/article/SB122204250955761325.html?mod=googlenews_wsj. In this article, Mr. Chanos notes that in the spring of 2007, he and another fund manager warned G-7 finance ministers and central bankers about a looming crisis in credit structures and overleveraged banks and brokerage firms. In May 2008, David Einhorn of Greenlight Capital publicly questioned Lehman Brothers' accounting at an investment research conference. *See* Remarks of David Einhorn before the Ira W. Sohn Investment Research Conference (May 21, 2008), *available at* http://www.foolingsomepeople.com/main/TCF%202008%20Speech.pdf. Einhorn also informed the press in December 2007 that the firm was not properly writing down the value of asset-backed securities. Svea

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Indeed, as we discuss further below, we believe that, when the impact of the ban on short sales of financial stocks is fully evaluated, the data will show that the ban had adverse effects on investors, issuers, and the markets by increasing volatility, reducing liquidity, clouding price discovery, preventing effective hedging in rapidly declining markets, and severely impeding the convertible bond market.[16] To avoid these adverse consequences in the future, we urge the Commission to adhere to "regular way" rulemaking for any future action in this area.

**Comments on Interim Final Temporary Rule 204T**

In its release announcing the adoption of Rule 204T, the Commission cited concerns about potentially abusive "naked" short selling.[17] We believe that Rule 204T, together with the recently adopted antifraud Rule 10b-21,[18] and the elimination of the options market makers' exception to Regulation SHO's close-out requirements,[19] should serve to greatly diminish the amount of delivery failures in securities, thereby helping to prevent potentially abusive naked short selling.

Unlike Rule 203(b)(3) of Regulation SHO, which imposes a close-out requirement with respect to securities with substantial and persistent levels of fails to deliver (i.e., "threshold securities"[20]), Rule 204T imposes a close-out requirement for all equity securities that have a fail to deliver position on the settlement date. Specifically, it requires participants of a clearing agency to deliver securities for clearance and settlement on a long or short sale in any equity security by settlement date or, if they have not done so, to immediately purchase or borrow securities to close out the fail-to-deliver position by the beginning of regular trading hours on the next settlement day, with three exceptions. Longer close-out periods are permitted for failures to deliver securities attributable to long sales, sales under Rule 144 of the Securities Act of 1933, and bona fide market making by a certain market makers.[21] A firm that fails to do so, and any

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Herbst-Bayliss, *Einhorn's Call On Lehman Seen As Right*, Reuters, Sept. 15, 2008, *available at* http://www.reuters.com/article/innovationNewsFinancialServicesAndRealEstate/idUSN1551364220080915.

[16] *See* text accompanying notes 42 through 64, *infra*.

[17] Amendments to Regulation SHO, *supra* note 4.

[18] *See* "Naked" Short Selling Antifraud Rule, Release No. 34-58774 (Oct. 14, 2008), 73 Fed. Reg. 61666 (Oct. 17, 2008).

[19] *See* Amendments to Regulation SHO, Release No. 34-58775 (Oct. 14, 2008), 73 Fed. Reg. 61690 (Oct. 17, 2008).

[20] *See* Rule 203(c)(6) of Regulation SHO for the formal definition of the term "threshold security."

[21] Rule 204T(a)(1)-(3). Where the fail to deliver results from a long sale, the participant has until the beginning of regular trading hours on the third consecutive settlement day following the settlement date to close out the position. Where the sale is under Rule 144 of the Securities Act, the participant must close out the fail-to-deliver position by the beginning of regular trading hours on the thirty-sixth consecutive settlement day following the settlement date. Where the fail to deliver is attributable to bona fide market making by a registered market maker, options market maker, or other market maker obligated to quote in the over-the-counter market, the participant must close out the

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broker-dealer from which it receives trades for clearance and settlement, may not thereafter, until the fail-to-deliver position is closed out, sell the security short, for itself or for another person, unless it has borrowed or arranged to borrow the security.

We support Rule 204T generally and also support the exceptions for Rule 144 sales and market making, but we question the Commission's disparate treatment of long and short sellers under the Rule. Under Rule 204T, if a participant of a registered clearing agency has a fail to deliver position in an equity security and is able to demonstrate that such fail to deliver position resulted from a long sale, the participant has two additional settlement days in which to close out the fail to deliver. According to the release adopting Rule 204T, "fails to deliver may occur from long sales within the first two settlement days after settlement date for legitimate reasons," such as "human or mechanical errors or processing delays [that] can result from transferring securities in custodial or other form rather than book-entry form."[22] However, there also are similar legitimate reasons for delivery failures in short sales. Indeed, human or mechanical errors and processing delays may result in delayed deliveries after a short sale, just as they may for a long sale. Therefore, if a grace period is permitted under the rule to remedy delivery failures for long sales, the same should apply for short sales.

The Commission has asked commenters to address specific questions relating to Rule 204T and Regulation SHO, including whether the Commission should amend the "locate" requirement of Rule 203(b)(1) of Regulation SHO to require that broker-dealers borrow or arrange to borrow equity securities prior to effecting a short sale in those securities, and whether it should define the term "arrangement to borrow" in Rule 203(b)(1) as requiring a contract between a broker-dealer and lender.[23] We do not believe it necessary to require a "contract" for delivery of borrowed shares, when the penalty for fails to deliver under Rule 204T should provide ample incentives for timely delivery. In the same vein, we do not believe there is a need to alter the "locate" provisions of Rule 203(b)(1) by requiring broker-dealers to borrow or arrange to borrow equity securities and eliminate their ability to rely on the reasonable belief that securities can be borrowed (currently reflected in paragraph (b)(1)(ii) of Rule 203) in order to effect short sales. Rule 203(b)(1) applies to all short sales, and not just short sales in threshold securities. Removing the ability to rely on a reasonable and good-faith belief would make short transactions more difficult to effect, even in cases where delivery failures have not posed a problem.

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fail to deliver position by the beginning of regular trading hours on the third consecutive settlement day following the settlement date.

[22] Amendments to Regulation SHO, *supra* note 4.

[23] 73 Fed. Reg. at 61717.

**Comments on Interim Final Temporary Rule 10a-3T and Reporting of Short Sale Information**

The Commission has stated that the purpose of Rule 10a-3T is to "provide useful information to the staff to analyze the effects of our rulemakings relating to short sales and in evaluating whether our current rules are working as intended."[24] The rule requires certain institutional investment managers to report information concerning short sales and short positions in Section 13(f) securities, other than options, on temporary Form SH.[25] While the initial Emergency Order requiring certain short sale reports provided that such information would be publicly available,[26] and a later amendment stated that such information would be made public two weeks after filing,[27] we agree with the ultimate determination of the Commission that such public disclosure is potentially harmful to the markets and that it is unnecessary for the Commission's stated purpose of providing the agency's *staff* information to analyze the impact of the Commission's other short sale rules. We therefore support the Commission's decision to provide in Rule 10A3-T that Form SH data shall be nonpublic.

The Commission nevertheless has requested comment on whether the information required by Form SH should remain confidential or be publicly reported. While we concur with the Commission's final iteration of Rule 10a-3T as a non-public filing, we would be remiss if we did not also note that the need to promulgate multiple versions of the rule demonstrates the very weakness of acting without due notice and public comment. We appreciate, however, the opportunity to make an ex post facto comment here on this important topic.

To begin, public disclosure of the information on Form SH, which may include trade secrets and proprietary information, would be contrary to long-standing Commission rules and practice, as well as federal law and the rules of numerous other federal agencies, which recognize the need to protect businesses from the economic and competitive disadvantages that would result from public disclosure of such information. For example, the Federal Trade Secrets Act recognizes the need to protect confidential trade secrets by setting criminal penalties for the unauthorized revelation of trade secrets.[28] Moreover, Exemption 4 of FOIA[29] and Rule 80(b)(4)

[24] Disclosure of Short Sales and Short Positions by Institutional Investment Managers, *supra* note 6.

[25] *See id.*

[26] *See* Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Release No. 34-58591 (Sept. 18, 2008), 73 Fed. Reg. 55175 (Sept. 24, 2008) at n. 6.

[27] Amendment to Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Release No. 34-58591A (Sept. 21, 2008), 73 Fed. Reg. 55557 (Sept. 25, 2008) at n. 8.

[28] 18 U.S.C. § 1905.

[29] 5 U.S.C. § 552(b)(4).

of the Commission's Rules of Practice under FOIA[30] provide that the Commission generally will not publish or make available to any person matters that would "[d]isclose trade secrets and commercial or financial information obtained from a person and privileged and confidential [information]." Disclosure of information relating to investment managers' short positions in securities, as was originally contemplated, would unfairly penalize investment managers and their investors, expose them to retaliation, undermine public markets, and confuse other investors without providing any material public policy benefit.

In connection with the reporting requirement for long position reporting under Section 13(f) of the Exchange Act,[31] Congress specified that the Commission, upon request, should exempt from public disclosure information submitted to the Commission when disclosure would reveal an investment manager's ongoing trading programs.[32] In fact, the legislative history of Section 13(f) set forth in the Senate Banking Committee report emphasized that "[t]he Committee believes that generally it is in the public interest to grant confidential treatment to an ongoing investment strategy of an investment manager. Disclosure of such strategy would impede competition and could cause increased volatility in the market place."[33] These same policy considerations should apply with respect to disclosure of short positions.

The Commission has the right to obtain and review confidential information about short positions for market surveillance purposes, but forcing public disclosure of individual positions of investment managers would have multiple serious consequences for the market. Financial institutions would lose their ability to manage assets without revealing their strategies. Also, as the Commission has found, disclosure of such data may "give rise to additional, imitative short selling."[34] Indeed, public disclosure of short positions could trigger panicky selling if investors see which institutions have shorted a stock. We discuss these and other concerns with respect to public disclosure in more detail below.

*Public disclosure will cause competitive harm.* Institutional investment managers filing Form SH could suffer competitive harm if their short sale positions were disclosed to the public. Investment managers who employ a fundamental short strategy seek to identify issuers whose equity securities are overvalued. In this regard, they conduct rigorous, costly financial analyses

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[30] 17 C.F.R. § 200.80(b)(4). *See also* Division of Corporation Finance Staff Legal Bulletin No. 1 (Feb. 28, 1997) and Addendum to Staff Legal Bulletin No. 1 (July 11, 2001).

[31] 15 U.S.C. § 78m(f). Under Section 13(f), certain investment managers must report long positions quarterly, 45 days after the end of each calendar quarter. Under the Commission's rules, these filers may request confidential treatment of trade secrets and commercial or financial information, and the Commission must consider each request and make a determination as to whether or not to make their information public. 17 C.F.R. §§ 200.80(b)(4), 200.83.

[32] *See* Commission Notice Re: Section 13(f) Confidential Treatment Requests (June 17, 1998).

[33] Report of Senate Committee on Banking, Housing & Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. 87 (1975).

[34] Order Amending and Extending Emergency Order Requiring Institutional Money Managers to Report New Short Sales, Release No. 34-58724 (Oct. 2, 2008), 73 Fed. Reg. 58987 (Oct. 8, 2008) at 2.

that focus on whether an issuer has an unsustainable or operationally flawed business plan, has materially overstated earnings, or otherwise engaged in fraud. Such managers gather information from a wide array of sources, beginning with an issuer's financial statements and other reports filed with the Commission and other regulators. Similarly, they may review the businesses of issuers' competitors, affiliates and counterparties to significant transactions. Some managers employ accountants and financial analysts, and may also hire research analysts for these purposes. These research practices may have been developed over years of experience and at great expense. As a former chief economist for the Commission has noted, disclosure of short positions would allow some traders to be "free riders," copying the positions of others, and benefiting themselves while reducing the gains that would otherwise accrue to those that actually performed the research.[35] In this manner, successful investment managers will bear the expenses of "copycat" investment managers. Disclosure of the information contained in Form SH, even after a substantial lapse of time, would reveal such managers' trading strategies, and ultimately prejudice the investors in the funds they advise, including pension funds, universities and endowments.

*Public disclosure of short positions in equity securities could shift trading to less transparent markets and compromise strategies.* Public disclosure of Form SH data is also likely to result in the transfer of short sale activity to less transparent markets, such as those for swaps, credit default swaps and other derivative transactions. In order to avoid public disclosure of their positions, institutional investment managers may unwind hedged long and short positions, and choose instead to engage in derivative trades that have the same economic effect as a short sale, but which are less transparent. In addition, public disclosure could compromise the ability of investment managers to engage in portfolio risk management strategies. Many investment managers accumulate short positions gradually over time in order to minimize the market impact of their investments. Indeed, some managers may enter a position over a period of years. Their ability to do so would be adversely affected if other investors can imitate their moves by reviewing periodic disclosure of their activity.

*Public disclosure exposes financial institutions to retaliation.* Public disclosure of short positions on Form SH would unfairly expose financial institutions to retaliation by companies and the risk of "short squeeze" campaigns. In a "short squeeze," other market participants seek to drive share prices upwards by buying shares in the open market, recalling loaned shares and/or preventing other shares from being lent out. A squeeze forces short sellers to buy shares at high prices in order to cover their positions, thus driving up the price of shares even more. A squeeze can result in substantial losses for a financial institution holding a short position and lead to increased volatility, as evidenced by the recent machinations in trading of Volkswagen which

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[35] *See Cox Seeks Emergency Disclosure Rule; Market, Hedge Funds React With Dismay*, BNA, Inc. Daily Report for Executives, No. 182, Sept. 19, 2008, at A-33 ("Chester S. Spatt, a finance professor at Carnegie Mellon University and a former chief economist for the SEC . . . agreed that the proposed disclosure would allow other short sellers to imitate very quickly the trades of the hedge fund disclosing its short position, resulting in the hedge fund not being able to reap the full benefit of the information it produced.").

briefly made it the largest company in the world measured by market capitalization.[36] Moreover, if there is any doubt that some officers of publicly held companies would squander their companies capital on such manipulation, rather than using it to address weaknesses in their companies' operations, one need only look to documents produced in recent congressional hearings: In an e-mail to Lehman Brothers' Chief Executive Officer, one senior executive stated "I like the idea of aggressively going into the market and spending [$2 billion of a $5 billion financing] buying back lots of stock (and hurting [David] Einhorn bad!!)."[37]

In addition, public disclosure would expose financial institutions to retaliation as issuers cut off communications with analysts at institutions who report short positions in the issuers' securities. This type of retaliation prejudices institutional investment managers and their clients and, more broadly, the process of price discovery.

*Public disclosure may confuse investors.* Short selling in a company's stock can occur for a variety of reasons and not necessarily because the short seller has a negative view of a company's outlook. For example, a financial institution may take a short position to lock in a spread or hedge an investment in convertible bonds by shorting the same company's equity. Traders also buy options and/or futures on stock indices and then short the individual component equities in order to profit from arbitrage opportunities. In these instances, public disclosure of short sale positions may mislead investors, who may incorrectly assume that the institution has a negative view of the company whose stock is being shorted.

For all of these reasons, CPIC supports the Commission's decision to make Form SH filings non-public. We also recommend that the Commission further revise Rule 10a-3T. First, we suggest that the Commission reduce the frequency and scope of reports on Form SH. Under Rule 10A-3T, certain institutional investment managers must report on Form SH all short sales and short positions in Section 13(f) securities (other than options), except those that fall below certain minimum reporting thresholds[38] in any week following a calendar week in which the

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[36] *See* Jeffrey Cane, *VW Über Alles*, Oct. 28, 2008, *available at* http://www.portfolio.com/news-markets/top-5/2008/10/28/Volkswagen-Is-the-Biggest-Company ("Automakers everywhere are getting battered by an economic slowdown, but today Europe's top carmaker is the biggest company in the world. Because of a freak event, shares of Volkswagen have spiked, giving it a market value of $370 billion, surpassing that of Exxon Mobil . . . On Sunday, Porsche unexpectedly disclosed that it had raised its stake in Volkswagen to 74.1 percent from 35 percent, through the use of derivatives. . . . The price spike resulted from a squeeze. A number of hedge funds had shorted VW shares, betting that the company, like other automakers, would fall in the market as consumers cut back spending."); Sarah Marsh, *Short sellers make VW the world's priciest firm*, Reuters, Oct. 28, 2008, *available at* http://www.reuters.com/article/ousiv/idUSTRE49R3I920081028.

[37] *Causes and Effects of the Lehman Brothers Bankruptcy: Hearing Before the H. Comm. on Oversight & Government Reform*, 110 Congress (Oct. 6, 2008) (statement of Henry Waxman, Chairman, H. Comm. on Oversight and Government Reform), *available at* http://oversight.house.gov/documents/20081006101958.pdf. Mr. Einhorn had been critical of Lehman and was believed at the time to hold a short position in Lehman stock.

[38] *See* Disclosure of Short Sales and Short Positions by Institutional Investment Managers, *supra* note 6. A manager need not file a Form SH if (1) the manager did not effect any short sales of Section 13(f) securities during the applicable reporting period; or (2) for each day during the relevant calendar week, its short position at the start

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manager effected a short sale in a Section 13(f) security. We believe that short sale reporting should be required no more frequently than is the case for Form 13F filers, unless the Commission has a specific need to review short sale data in particular securities on a more immediate basis.

In addition, we believe that the scope of Form SH reporting is overbroad. If the Commission needs short sale information to evaluate the impact of its short sale rules, we see no reason to require filers to report the entirety of their short positions in all securities in any week in which a filer makes only one trade in a Section 13(f) security that is required to be reported on Form SH. In fact, we believe that any Form SH that is required to be filed should report only new short sale positions that have not been previously reported or which have changed since the date of the earlier Form SH report. We also believe that reporting should be limited only to short sales of securities that have a high level of short interest.

CPIC believes that the Commission should have the information that it needs in order to police the securities markets. However, the Commission should consider alternatives to requiring filing such data by multiple investment managers on a weekly basis. For example, in lieu of a filing on Form SH, short sellers could be required to retain and make available for Commission inspection detailed books and records relating to their short sale activity. This alternative would preserve confidentiality while at the same time providing the Commission with necessary data on short sale activities.

Finally, if the Commission is truly interested in understanding the impact of short selling on the market and the effectiveness of its existing rules, there appears to be no reason to limit short sale reporting to 13F filers as the Commission has done in this rule. The Commission should consider adding market makers and other large traders taking short positions, such as "quants" and index traders, to the group of market participants required to report significant short sale activity.

**Comments on the Commission's Prior Short-Selling Ban**

Recent months have been exceedingly difficult for the capital markets and financial regulators. Excessive leverage, especially in dubiously-rated mortgage-backed securities, has caused precipitous declines in credit worthiness of financial institutions. As the market priced the shares of financial institutions downward, the Commission stepped in with hurried

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and end of the day, and the gross number of securities sold short during the day, constitute less than 0.25% of that class of the issuer's Section 13(f) securities issued and outstanding as reported on the issuer's most recent annual, quarterly or current report filed with the Commission, unless the manager knows or has reason to believe that information is inaccurate, and the fair market value of the short positions at the start and end of each day, and of the gross number of securities sold short during the day, is less than $10 million.

emergency measures to restrict or ban short selling in "financial" stocks.[39] In recent weeks, there have been calls to reinstitute the ban, and we therefore provide the comments below.

According to Amity Shlaes, author of *The Forgotten Man: A New History of the Great Depression*, one of the parallels between the recent past and that of 80 years ago is that "they had a witch-hunt against their short sellers in the early 1930s just as we have a lot of pressure on the short sellers now, making short sales illegal, [and complaining about] hedge funds . . . ." Ms. Shlaes noted, "Hedge funds did not cause this problem."[40] We hope that a second parallel to the 1930s does not develop: one where economic recovery is slowed by refusal to recognize true causes and continued blame on the messengers. As recently stated by Nobel economics laureate Gary Becker, "[t]he temporary banning of short sales is an example of a perennial approach to difficulties in financial markets and elsewhere; namely, 'shoot the messenger.' Short sales did not cause the crisis, but reflect beliefs about how long the slide will continue."[41]

As the Commission is aware, during the period in which the ban was in place, the equity markets generally and the shares of financial companies in particular continued their overall decline. What further proof is needed that short selling did not cause the problems in the financial sector than the fact that, while short selling of financial stocks was limited around the globe, their prices continued to plummet?[42] The ban did nothing to prevent the stock of Ambac Financial Group Inc. and Federal Agricultural Mortgage Corp. from tumbling more than 50 percent between September 18 when the ban was issued and September 24.[43] Similarly, it did nothing to prevent the precipitous drop in share price, and ultimate failure of, Washington

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[39] *See* SEC Releases, *supra* notes 10-11. The broad meaning of "financial" stocks permitted the management of companies such as IBM, Sears, CVS Caremark and Zale Corp. to seek to be placed on the protected list of "financial" issuers by their listing exchanges. No doubt Enron could have made the case to be deemed "financial" as well.

[40] "Morning Joe," MSNBC, Oct. 13, 2008. Ms. Shlaes is a syndicated columnist for Bloomberg and a senior fellow at the Council on Foreign Relations.

[41] Gary S. Becker, *We're Not Headed for A Depression*, Wall St. J., Oct. 7, 2008, *available at* http://online.wsj.com/article/SB122333679431409639.html.

[42] *See* Gregory Zuckerman, *Don't Blame Short Selling*, Wall St. J., "Heard on the Street," Sept. 30, 2008 ("Perhaps short sellers weren't the problem after all. Financial companies continue to crumble, despite the recent ban on short selling of these firms. It is a stark reminder of the error of placing a bull's-eye on short sellers. While investors can't add new short positions, Wachovia was forced to sell itself . . . while Morgan Stanley and Goldman Sachs Group shares tumbled more than 10% Monday. There was never any clear evidence that short selling was on the rise lately. Some data show that short selling of financial shares actually has fallen in the past few months.").

[43] *See* Nick Baker & Eric Martin, *Short-Sale Ban Fails to Save Ambac From 50% Plunge (Update1)*, Bloomberg, Sept. 25, 2008.

Mutual,[44] or the plunge in share price of Wachovia Bank that led to its efforts to be acquired.[45] Declines in the fortunes of European financial firms, such as Fortis, Hypo Real Estate AG, and Dexia SA, also continued, notwithstanding restrictions on short sales that European market regulators imposed.[46] Poor credit management and poor business and investment decisions -- not short sellers -- brought about these results.[47]

*Legitimate trading strategies, including long trades, were impeded.* Short selling is inextricably interwoven with many trading strategies, such as convertible arbitrage. The ban had the effect of severely limiting the ability of managers to rely on such strategies. For example, according to data provider Hedge Fund Research, convertible bond arbitrage, which involves hedging a convertible bond purchase by shorting the underlying shares, fell by 16.3% between September 22 and September 28.[48] Because investors were not permitted to sell short the shares of financial issuers, there was less interest in buying convertible bonds, which tends to increase the cost of capital for issuers.[49] As noted in the Wall Street Journal, the convertible bond market is "a crucial area of financing for struggling companies . . . [who] in times of stress ... turn to convertibles in order to raise capital when a share price has fallen."[50] The ban also prevented

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[44] *See* Jeff Feeley & Steven Church, *Washington Mutual Lists $8 Billion Debt in Bankruptcy (Update1)*, Bloomberg, Sept. 27, 2008 (noting that the stock of Washington Mutual Inc. had fallen 98 percent in the past year due to losses tied to subprime lending), *available at* http://www.bloomberg.com/apps/news?pid=20601087&sid=a_WW5ZH_P_A0&refer=home.

[45] *See* Alistair Barr & John Spence, *Citi To Buy Wachovia Banking Business For $2.16 Bln*, MarketWatch, Sept. 29, 2008, *available at* http://www.marketwatch.com/news/story/citigroup-acquire-wachovias-banking-operations/story.aspx?guid=%7B633CD0D5-5FFA-42B8-BBF3-0E6402BEE599%7D&print=true&dist=printMidSection.

[46] Scheherazade Daneshkhu & Ben Hall, *Dexia Receives €6.4bn Funding From European Governments*, Financial Times, Oct. 1, 2008.

[47] *See* James Mackintosh, *Funds Seek End To Ban On Short Selling*, Financial Times, Sept. 29, 2008 (noting that "[m]any of London's biggest hedge fund managers pointed out in private that Bradford & Bingley and Fortis needed government rescues even though short selling was no longer possible, while shares in financial companies had fallen in Europe and the US since the rally after the ban was introduced."), *available at* http://www.ft.com/cms/s/0/2ca3e354-8e53-11dd-9b46-0000779fd18c,dwp_uuid=1f4e12ca-53ec-11dd-aa78-000077b07658.html.

[48] *See* David Walker, *Short-Selling Is Down But Not Out As Industry Fights Back*, Dow Jones Financial News, Sept. 29, 2008.

[49] According to an article dated September 26, 2008, data provider Dealogic found that there were no convertible issues sold in the U.S. after the first week of September through the date of the article. *See* Alistair Barr, *Short-Sale Ban Disrupts Trades For Hedge Funds, MarketWatch*, Sept. 26, 2008, *available at* http://www.marketwatch.com/news/story/hedge-funds-suffer-short-selling/story.aspx?guid=%7BA12A0C0D-55FF-4576-9F2B-9D4C9072200E%7D&dist=msr_1).

[50] *See* Tom Lauricella, *Short-Sale Ban Wallops Convertible-Bond Market*, Wall St. J., Sept. 26, 2008.

investors from using short sales in financial stocks to hedge their positions in those or other securities, thereby discouraging investors from taking on new long positions. [51]

*Liquidity dried up, volatility increased, and spreads widened.* With the ban on short selling in a wide group of stocks, liquidity diminished, as buyers who typically look to hedge their investments through short sales, as well as other traders who rely upon short sales as part of their trading strategies, exited the market. An article in the Wall Street Journal noted that "[b]etween Sept. 22 and Sept. 29, overall trading volumes fell 41.1% from the week of Sept. 15-19, ... [and] volume in the restricted stocks was down 49.6%." [52] Before the short sale ban, consolidated equity volume ranged around 18.7 billion shares on September 18, but plunged to about 8 to 9 billion shares in the weeks after.[53]

The Wall Street Journal also reported that, as would be expected from lost liquidity, bid-ask spreads in restricted stocks rose sharply -- from 0.15 percentage points to almost 0.40 percentage points.[54] Commentators have noted that the global crackdown on short selling made markets more erratic and volatile and may have contributed to falling share prices because of the disappearance of short sellers, whose short covering provides a key cushion.[55] A study by Nasdaq OMX of the ban found that stocks covered by the ban became more volatile.[56] The Chicago Board Options Exchange Volatility Index (a widely used measure of market volatility

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[51] To illustrate, a manager of an equity fund that focuses on long strategies cannot effect short sales in order to create a sufficient hedge, so he or she may be forced to forego, or even liquidate, some long positions. *See* Alistair Barr, *Short-Sale Ban Disrupts Trades For Hedge Funds*, MarketWatch, Sept. 26, 2008 (noting that some traders may have used a similar strategy, judging by the performance of the stock market during the Commission's ban), *available at* http://www.marketwatch.com/news/story/hedge-funds-suffer-short-selling/story.aspx?guid=%7BA12A0C0D-55FF-4576-9F2B-9D4C9072200E%7D&dist=msr_1).

[52] Tom Lauricella et al., *SEC Extends "Short" Ban as Bailout Advances*, Wall St. J., Oct. 2, 2008, at C1; *see also* James Mackintosh, *Short Shrift*, Financial Times, Oct. 6, 2008.

[53] See Nina Mehta, *Short-Sale Ban Chases High-Frequency Traders From the Market*, Traders, Sept. 29, 2008.

[54] Tom Lauricella, Kara Scannell and Tennille Tracy, *SEC Extends "Short" Ban as Bailout Advances*, Wall St. J., Oct. 2, 2008; *see also* James Mackintosh, *Short Shrift*, Financial Times, Oct. 6, 2008.

[55] *See* Jonathan Spicer, *Short Ban Seen Exacerbating Sharp Market Drop*, Reuters, Sept. 30, 2008, *available at* http://www.reuters.com/article/ousiv/idUSTRE48T7PT20080930. *See also* Seth Freedman, *We've Been Sold Short*, The Guardian, Oct. 17, 2008 ("The S&P 500 index lost 21.5% of its value during the period of the ban, and the embargo was viewed by market experts as actually increasing volatility in the indices as a result -- hardly a desired side-effect of their prescriptive measure."), *available at* http://www.guardian.co.uk/commentisfree/2008/oct/17/shortselling-creditcrunch; Kara Scannell & Craig Karmin, *Short-Sale Ban Ends to Poor Reviews*, Wall St. J., Oct. 9, 2008 ("By the time it expired Wednesday night, the general view was that it added to market confusion and didn't do much to halt the slide in financial stocks.").

[56] *See* David Greising, *Short-selling ban leaves SEC with little to show*, Chicago Tribune, Oct. 10, 2008, *available at* http://archives.chicagotribune.com/2008/oct/10/business/chi-fri-crisis-greising-shorts-oct10.

determined by reference to S&P 500 stock index options) set new records on September 29 and October 6.[57] In addition, transaction costs increased and spreads widened.[58]

*Investment firms were forced to limit offerings.* Rydex Investments, the sponsor of several exchange traded funds, announced that due to the emergency action, the Rydex Inverse 2x S&P Select Sector Financial ETF (RFN), which was structured to move inversely to the financial sector, was "not expected to accept orders ... to create shares until further notice" and that although shares in that ETF were expected to continue trading, they might "trade at prices that are not in line with their intraday indicative values."[59] Similarly, ProShares, which also sponsors ETFs, was forced to refuse orders for the creation of shares of its Short Financials ProShares, and UltraShort Financials ProShares ETFs.[60]

*Price discovery was limited.* As the Commission is well aware, fundamental short sellers, in the process of discovering fraud, hidden risks or just poor management, correct inefficiencies in the market and can prevent other investors from losing money. In situations such as those presented by the current environment for financial institutions, the role of short sellers is perhaps more critical than ever. Short sale transactions help to bring share prices to levels supported by the fundamentals, decreasing the likelihood of price bubbles. Short selling also improves market quality and efficiency by narrowing spreads, improving the speed of price adjustments based on new information, and pumping liquidity into the market. If short sellers can not pursue their strategies in conventional markets, they may seek to employ them elsewhere, such as in the relatively opaque over-the counter market for credit default swaps, where the benefits that they provide to the securities markets would be diminished.

**Conclusion**

The U.S. securities markets have long been looked upon as a paragon of stability and predictability. But there are always those who only support free markets when stocks ascend and then prefer intervention during price corrections and a return to rational values. Adopting

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[57] *See* Jeff Kearns, *VIX Jumps to Record, Topping 56, on 'Mad Rush' to Sell Assets*, Bloomberg, Oct. 6, 2008; Jonathan Spicer, *Short Ban Seen Exacerbating Sharp Market Drop*, Reuters, Sept. 30, 2008, *available at* http://www.reuters.com/article/ousiv/idUSTRE48%7PT20080930; *see also* Chicago Board Options Exchange Introduction to VIX Futures and Options, *available at* http://www.cboe.com/micro/vix/introduction.aspx. *See also Comment: After the Ban*, Hedge Week, Oct. 13, 2008 (noting that since the ban commenced on September 19, trading volume on the New York Stock Exchange had dropped 35 percent and the Chicago Board Options Exchange Volatility Index surged to 57.53 on the day the ban ended).

[58] *See* Louise Story, *A Debate as a Ban on Short-Selling Ends: Did It Make Any Difference?*, N.Y. Times, Oct. 8, 2008 (noting that the spread on financial stocks increased by 42 percent), *available at* http://www.nytimes.com/2008/10/08/business/08short.html?partner=rssnyt&emc=rss.

[59] See Rydex Announcement on RFN, Sept. 19, 2008, *available at* http://www.marketwire.com/press-release/Rydex-Investments-901947.html.

[60] See Answers to Questions about SKF and SEF, *available at* http://www.proshares.com/AnnouncementonSKFandSEF.html.

policies that threaten the existence of deep and liquid securities markets has profound implications, not only for short sellers but for the integrity of our markets. When the U.S. government repeatedly intervenes by taking sudden, unpredictable actions to support stock prices of certain issuers or industry sectors, and does so without notice and comment, investors and market participants no longer can be confident that they are participating in stable, predictable markets. The result is that U.S. capital markets lose their status, credibility and competitiveness. The U.S. securities markets have been diminished by a series of actions targeting short sellers that were taken by the Commission without the benefit of notice and comment. Although we understand that the Commission acted in exigent circumstances and that many other countries took similar actions, we urge the Commission not to take any additional actions in this area without the benefit of notice and comment.

We thank you for this opportunity to provide our comments. We would be happy to discuss them at your convenience.

Sincerely,

James S. Chanos
Chairman
Coalition of Private Investment Companies

cc: The Honorable Luis A. Aguilar
Commissioner
The Honorable Kathleen L. Casey
Commissioner
The Honorable Troy A. Paredes
Commissioner
The Honorable Elisse B. Walter
Commissioner
Dr. Erik Sirri, Director
Division of Trading and Markets
Andrew J. Donohue, Esq., Director
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