

MEMO# 23128

December 18, 2008

ICI Comment Letter on SEC Interim Final Rules to Address Manipulative Short Sale Activity

[23128]

December 18, 2008

TO: EQUITY MARKETS ADVISORY COMMITTEE No. 66-08
SEC RULES MEMBERS No. 140-08
ACCOUNTING/TREASURERS MEMBERS No. 35-08
CLOSED-END INVESTMENT COMPANY MEMBERS No. 64-08
COMPLIANCE MEMBERS No. 64-08
ETF ADVISORY COMMITTEE No. 37-08
INVESTMENT ADVISER MEMBERS No. 20-08 RE: ICI COMMENT LETTER ON SEC INTERIM
FINAL RULES TO ADDRESS MANIPULATIVE SHORT SALE ACTIVITY

As we previously informed you, the Securities and Exchange Commission has published two interim final rules to address market manipulation and abuses related to short selling. [\[1\]](#) The first – temporary interim final Rule 10a-3T – requires institutional investment managers to report to the Commission certain information concerning their short sales and short positions. [\[2\]](#) The second – temporary interim final Rule 204T – requires broker-dealers to purchase or borrow securities to close out fail to deliver positions. [\[3\]](#) The Institute's letters commenting on these proposals are attached and summarized below.

The Disclosure Letter supports interim final Rule 10a-3T and the Commission's need to obtain information from institutional investment managers to analyze the effects of its rulemaking relating to short sales and to consider when questions about the propriety of certain short selling occur. It urges the Commission, however, to balance these needs with

the regulatory burdens imposed on market participants by the new disclosure requirements and the potential unintended consequences of those requirements. Most importantly, the letter requests that the Commission retain the portion of the interim final rule that makes the information submitted under the disclosure requirements nonpublic. It also includes a series of recommendations to help the Commission to reduce the costs and burdens on investment managers subject to the required disclosures.

The Disclosure Letter strongly urges the Commission to retain the nonpublic status of the information provided on Form SH, noting that such a limitation would not impede the purposes of the interim final temporary rule, as described above. The letter explains that the confidentiality of information about a fund's securities holdings is a critical issue to Institute members, and that any leakage of this information can lead to frontrunning of a fund's trades, adversely impacting the price of the stock that the fund is buying or selling to the detriment of fund shareholders. It also highlights several other unintended consequences of public disclosure of the information on Form SH, such as increased shorting of certain stocks as market participants imitate firms' publicized short positions. In addition, the letter notes that public disclosure of this information may confuse investors and other market participants about an investment manager's intentions. [\[4\]](#)

The Disclosure Letter recommends that Form SH be filed on a more reasonable and appropriate timeframe, such as 45 days after the end of a quarter, instead of the weekly period provided by the interim temporary final rule. It suggests that such a filing requirement would more appropriately balance the Commission's need to monitor short sale activity with the costs and burdens of producing Form SH data without lessening the Commission's ability to monitor for manipulative short selling.

C. Clarify Aggregation Requirements Under the Rule

Under Rule 10a-3T, the Commission suggests that investment managers are required to aggregate the holdings of control affiliates to determine whether the affiliates or the parent company would be required to file reports under Form SH. The Disclosure Letter recommends that the Commission clarify that when investment managers are deemed to share investment discretion only because of control relationships and affiliates do not share information about investment decisions for business purposes, short positions of affiliates should not be required to be aggregated to determine whether there is a reportable short position for the affiliate group.

D. Expand Exceptions to the Rule's Reporting Requirements

The interim final rule includes a filing exception from the reporting requirements for short sale activity falling under certain thresholds. Specifically, the exception has two separate prongs that must be satisfied before an investment manager is entitled to operate under it: a “fair market value” test and a “percentage of shares outstanding” test. The Disclosure Letter recommends that the threshold in the “percentage of shares outstanding” test be increased from 0.25 percent to more accurately reflect the capture of positions with the potential to materially affect the price of the underlying securities (e.g., 2 percent). It also recommends that the Commission bifurcate the two-part test into separate standards, either of which may be satisfied for an investment manager to qualify for the reporting exception.

E. Limit the Reportable Information to Short Positions

The Disclosure Letter requests that the Commission require only the disclosure of short positions instead of short sales and short positions. It states that short position information would provide the Commission with the data it needs to evaluate any significant market impact of a manager’s short activity, and the effectiveness of the Commission’s short sale rules, while appropriately balancing the high costs on market participants of developing and operating new systems to collect, compile, and reconcile short sale activity data.

F. Create Consistency with Regulations in Other Jurisdictions

The Disclosure Letter concludes by urging the Commission to work closely with foreign regulators to create consistent and sensible cross-border regulations for short sale activity. It emphasizes the importance of avoiding negative consequences of incongruent regulatory requirements and capitalizing on regulatory synergies as fund managers pursue an increasing cross-border presence in the interest of shareholders.

II. Close-out Requirement – Rule 204T

The Close Out Letter supports interim final Rule 204T and the Commission’s effort to inhibit abusive “naked” short selling through the requirement that securities be purchased or borrowed to close out any fail to deliver position. The letter encourages the Commission, however, to consider the unintended consequences that the interim final rule may have on the securities lending market and to adopt any appropriate modifications. Specifically, the letter explains that certain aspects of Rule 204T associated with the timing and close-out process may act as a disincentive to investment managers to lend their securities. It explains that a reduction in securities lending programs may impinge on the liquidity and price discovery benefits of short selling contrary to the Commission’s goal underlying

adoption of the interim final rule.

The Close Out Letter makes three specific recommendations to the Commission to address some of the unintended consequences of Rule 204T. First, it recommends that the Commission expeditiously undertake a review of the impact of the rule's provisions on securities lending activities and identify ways to modify the rule to reduce untoward effects and costs. Second, it recommends that the Commission clarify the difference between a close out on the open on T+6 and a buy-in earlier to obtain pre-fail credit. [5] Third, it recommends that the Commission allow the close out on T+4/T+6 to occur via a weighted price order, such as a volume-weighted average price (i.e., VWAP), on that day, not just through an opening trade as specified in the interim final rule.

Heather L. Traeger
Assistant Counsel

[Attachment](#)

endnotes

[1] See Memorandum to ETF Advisory Committee No. 32-08, Equity Markets Advisory Committee No. 56-08, SEC Rules Committee No. 74-08, Closed-End Investment Company Committee No. 33-08, Accounting/Treasurers Committee No. 13-08, Chief Compliance Officer Committee No. 17-08, Compliance Advisory Committee No. 17-08, and Investment Advisers Committee No. 10-08, dated October 23, 2008 [23013].

[2] See Disclosure of Short Sales and Short Positions by Institutional Investment Managers, SEC Release No. 58785 (October 15, 2008), 73 FR 61678 (October 17, 2008) ("Disclosure Letter").

[3] See Amendments to Regulation SHO, SEC Release No. 58773 (October 14, 2008), 73 FR 61706 (October 17, 2008) ("Close Out Letter").

[4] The Disclosure Letter also requests that the Commission clarify its statement that Form SH information will remain nonpublic "to the extent permitted by law" and specifically state its intention to exercise this authority as a matter of course to preserve the nonpublic status of all Form SH information.

[5] Rule 204T provides that sellers of equity securities and their broker-dealers deliver

securities by the close of business on settlement date – i.e., T+3. Fail to deliver positions must be closed out no later than the beginning of regular trading hours on the settlement day following the day the fail to deliver position occurs, which, generally, will be T+4 for a short sale or T+6 for a long sale.

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.