

**MEMO# 22550**

May 21, 2008

## **ICI Comment Letter on SEC's Proposed Anti-Fraud Short Sale Rule**

[22550]

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TO: EQUITY MARKETS ADVISORY COMMITTEE No. 23-08  
ETF ADVISORY COMMITTEE No. 12-08  
SEC RULES MEMBERS No. 45-08  
CLOSED-END INVESTMENT COMPANY MEMBERS No. 18-08     RE: ICI COMMENT LETTER ON  
SEC'S PROPOSED ANTI-FRAUD SHORT SALE RULE

The Securities and Exchange Commission recently published for comment proposed Rule 10b-21 under the Securities Exchange Act of 1934 – an anti-fraud rule designed to address failures to deliver securities that have been associated with “naked” short selling. [\[1\]](#) Specifically, the proposed rule would make it an anti-fraud violation for a short seller to deceive certain specified persons about their intention or ability to deliver securities in time for settlement, including short sellers that deceive their broker-dealer about the source or ownership of shares, and that fail to deliver securities by settlement date. The proposed rule also would include a scienter requirement.

The Institute has filed a comment letter supporting the Commission’s proposal to target abusive naked short selling. The letter, which is attached and summarized below, seeks clarification on several aspects of the proposal.

### **Scienter and Delivery Requirement**

The letter strongly supports the scienter requirement in the proposed rule. The letter explains that the scienter requirement is critical to avoid treating inadvertent, temporary

fails to deliver as violations of the proposed rule. The letter also states that the delivery requirement (i.e., failure to deliver the securities by settlement date) in the proposed rule is unnecessary if the scienter requirement is adopted. The letter explains that the proposed rule is designed to target deceptive conduct in connection with a seller's intention or ability to deliver securities timely for settlement. So, the fact that a security is delivered on time should not be dispositive as to whether a deception concerning delivery occurred at the time of sale. Instead, the letter recommends that the delivery requirement be a factor in determining whether the necessary scienter was present for establishing a violation of the proposed rule.

## **Locate Requirement**

The letter supports the stated design of the proposed rule to aid broker-dealers in complying with the locate requirement of Regulation SHO by holding responsible short sellers who deceive a broker-dealer about a locate (e.g., the source, ownership or ability to deliver shares). The letter recommends, however, that the Commission continue to permit a broker-dealer to rely on customer assurances, provided it is reasonable for the broker-dealer to do so, in satisfying the locate requirement. The letter explains that the potential costs of requiring investors to provide definitive proof that they own the security they are seeking to sell or to deliver the security to the broker-dealer prior to entering a sell order would significantly outweigh the benefits of such a requirement.

The letter also recommends that the Commission clarify that a short seller would not have to disclose, under the proposed rule, the source of any borrowed securities and that a seller must only disclose that it is "deemed to own the securities" as described in Regulation SHO. The letter also recommends that, if the Commission adopts the proposed rule, it abandon its outstanding proposal that would require broker-dealers to document the present location of securities being sold in any sale transaction marked as a "long" sale. [\[2\]](#)

## **Application of the Proposed Rule to ETFs**

The letter seeks clarification regarding the application of the proposed rule to ETFs, particularly the ETF creation and redemption process. The letter also offers to the Commission the Institute's assistance in examining the ETF issues.

## **Enforcement of Short Sale Rules**

The letter notes that the Institute does not support "rulemaking for the sake of rulemaking" but recognizes that the proposed rule will highlight the illegality of abusive naked short selling activities and the harm that these activities have on the securities markets. Accordingly, the letter recommends that the Commission's efforts to minimize "naked" short selling be accompanied by vigorous enforcement of the current and proposed short sale and anti-fraud rules.

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[Attachment](#)

**endnotes**

[\[1\]](#) See SEC Release No. 57511 (March 17, 2008), 73 FR 15375 (March 21, 2008).

[\[2\]](#) See SEC Release No. 56213 (August 7, 2007), 72 FR 45558 (August 14, 2007).

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