INVESTMENT COMPANY INSTITUTE

**MEMO# 23571**

June 19, 2009

# ICI Comment Letter on SEC Short Sale Regulation Proposal

[23571]

June 19, 2009

TO: SEC RULES MEMBERS No. 66-09
EQUITY MARKETS ADVISORY COMMITTEE No. 31-09
ETF ADVISORY COMMITTEE No. 18-09
CLOSED-END INVESTMENT COMPANY MEMBERS No. 24-09
EXCHANGE-TRADED FUNDS (ETF) COMMITTEE No. 3-09 RE: ICI COMMENT LETTER ON SEC SHORT SALE REGULATION PROPOSAL

As we previously informed you, [1] the Securities and Exchange Commission ("SEC") published for comment a proposal containing two general approaches to new restrictions on short selling. One approach would apply a price test on a market wide and permanent basis, similar to the former "bid test" or the former uptick rule under Rule 10a-1 of the Securities Exchange Act of 1934. The second approach would apply only to a particular security during a specified market decline in that security (a "circuit breaker") and would impose either a temporary price test or a temporary halt in short selling in the affected security. The Institute has filed the attached comment letter with the SEC on the proposal. The most significant aspects of the letter are summarized below.

**Proposed Restrictions on Short Selling**

The letter states that new restrictions on short sales are not warranted at this time. In particular, the letter states that SEC actions have already added necessary protections to address abusive short selling; empirical evidence is lacking that any of the proposed approaches would have alleviated any of the markets' recent volatility; as the SEC itself has acknowledged, there is uncertainty whether any of the proposed approaches would increase investor confidence in the markets; and there are potential unintended consequences of any new restrictions.

The letter states that if the SEC nevertheless determines that some form of new short sale restriction is necessary, the Institute would support a circuit breaker that triggers the “proposed modified uptick rule” as the approach that would have the least impact on legitimate short selling and normal market activity. Specifically, a circuit breaker triggering the modified uptick rule would have several advantages over the other proposed approaches. Most significantly, this alternative is more narrowly tailored than a permanent, market-wide short sale price test restriction, focusing on a particular security experiencing significant downward pressure on its stock price. In addition, the modified uptick rule in general has several advantages over the proposed uptick rule. Of the proposed circuit breaker price tests, the circuit breaker triggering the modified uptick rule would therefore be preferable than one that triggers the proposed uptick rule. Finally, allowing short selling to continue through a price test restriction once a circuit breaker is triggered might have a lesser impact on legitimate short selling and normal market activity than a circuit breaker that triggers a short selling halt that would temporarily prohibit any short selling in that security.

**Other Issues Relating to Proposed Short Selling Restrictions**

The letter addresses a number of additional issues that the SEC should consider prior to implementing any new short sale restrictions. Most significantly, the letter supports appropriate exceptions to any short sale restrictions the SEC may adopt. Specifically, it supports exceptions for exchange traded funds, market makers, and certain benchmark order types, including volume-weighted average price orders. Noting the deficiencies present under the prior short sale price test regime, the letter states that any new short sale regulations also must include a robust compliance and enforcement regime to provide investors with confidence that violations or abuses of those regulations will be detected and punished.

**Settlement of Short Selling Transactions and Pre-Borrowing Requirements**

The letter discusses recent suggestions that concerns relating to short sales could be addressed through a continued tightening of requirements relating to the SEC’s close-out requirements for fail to deliver positions, i.e., through some form of pre-borrowing requirement. The letter states that, at this time, and without further study of the potential impact on the securities markets, the Institute would not support a restriction on short selling that would be based on a pre-borrow requirement.  The letter also encourages the SEC to continue to review the implications of new short selling rules on securities lending and to address any unintended consequences for, or impediments to, the effective operation of the securities lending markets.

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Attachment

**endnotes**

[1] See Memorandum to SEC Rules Committee No. 18-09, Equity Markets Advisory Committee No. 17-09, ETF Advisory Committee No. 9-09, and Closed-End Investment Company Committee No. 5-09, dated April 20, 2009 [23407].