

## COMMENT LETTER

January 5, 2004

# ICI Comments on Efforts to Curb Short-Selling Abuses (pdf)

January 5, 2004 Mr. Jonathan G. Katz Secretary U.S. Securities and Exchange Commission  
450 Fifth Street, N.W. Washington, D.C. 20549-0609 Re: Short Sales (File No. S7-23-03)

Dear Mr. Katz: The Investment Company Institute<sup>1</sup> appreciates the opportunity to comment on the Securities and Exchange Commission's proposed Regulation SHO, which would modernize and replace existing Commission and self-regulatory organization ("SRO") rules governing short sales.<sup>2</sup> The Institute supports the Commission's proposal, which is designed to curb the abuses associated with short selling. As the Proposing Release notes, although short selling can have beneficial effects on the markets, such as adding market liquidity and pricing efficiency, it also can have several detrimental effects, most significantly when short selling is used to manipulate stock prices. The Institute has several comments on proposed Regulation SHO. In particular:

- We support the implementation of a uniform bid test and recommend that the test be extended to other less liquid securities not currently subject to short sale pricing restrictions (e.g., Nasdaq SmallCap securities).
- We support the implementation of a pilot program suspending the proposed bid test for certain highly liquid securities.
- We recommend that the Commission expand its current limited exemptive relief for VWAP transactions from the short sale rule.

<sup>1</sup> The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,601 open-end investment companies ("mutual funds"), 604 closed-end investment companies, 110 exchange-traded funds and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about \$7.240 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 86.6 million as of mid 2003, representing 50.6 million households.

<sup>2</sup> Securities Exchange Act Release No. 48709 (October 28, 2003), 68 FR 62972 (November 6, 2003) ("Proposing Release"). Mr. Jonathan G. Katz January 5, 2004 Page 2

- We strongly support the proposed uniform locate requirement to address problems associated with "naked short selling."
- We recommend that the requirements for a person to be considered "long" under proposed Rule 200 be modified to ensure that broker-dealers can continue to facilitate institutional investor block orders to sell at a VWAP or closing price. Our specific comments follow.

I. Proposed Uniform Bid Test Currently, short sale regulation applies different price tests to securities trading in different markets.<sup>3</sup> In order to create uniformity in the application of short sale regulation, proposed Regulation SHO would make short sale regulation consistent for exchange-listed and Nasdaq NMS securities, wherever traded, by implementing a uniform bid test.<sup>4</sup> The Institute supports the uniform bid test. A uniform test would simplify the regulation and utilization of short sales, not only for investors and other market participants, but also for regulators, and

should lead to better regulatory market oversight. A uniform bid test also would resolve the issue of having different markets applying different types of short sale rules (or none at all) to the same security.<sup>5</sup> Finally, the current short sale rules, in particular the tick test for listed stocks, have become outdated in a decimal trading environment. We have one comment on the scope of the proposed uniform bid test. As proposed, the uniform test would not apply to many smaller, less liquid securities (e.g., OTC Bulletin Board, Pink Sheet, and Nasdaq SmallCap securities), in part because these securities have not been subject to short sale pricing restrictions in the past and in part because of the lack of a true consolidated quote for certain of these securities. In general, the Institute believes that the Commission should apply the proposed uniform bid test broadly, to as many securities as possible. Extending the protections of the short sale rule to smaller, less liquid securities would ensure that investors in these securities are safeguarded from the type of manipulation that the short sale rule was designed to address. We recognize, however, that it may not be feasible to apply the uniform bid test to some of these securities, such as those trading through the OTC Bulletin Board or in the Pink Sheets, because of the absence of a consolidated best bid. The Institute therefore recommends that the Commission extend the application of the uniform bid test to Nasdaq SmallCap securities, as the Nasdaq Stock Market already disseminates consolidated bids for these securities. If systems are developed that would permit quotes to be 3 For example, Rule 10a-1 under the Securities Exchange Act of 1934 ("Exchange Act") imposes a "tick test" in determining whether a short sale transaction may occur in a listed security on a national securities exchange, while NASD Rule 3350 imposes a "bid test" with respect to short sale transactions in Nasdaq NMS securities. 4 Specifically, under proposed Rule 201, broker-dealers executing short sales would look to the consolidated best bid in a security as the reference point for measuring the permissibility of short sales. The uniform bid test would require that all short sales be executed at a price at least a penny over the then-current consolidated best bid for the security. 5 For example, a Nasdaq NMS security traded on a regional securities exchange pursuant to unlisted trading privileges may not be subject to any short sale regulation while the same security traded on the Nasdaq Stock Market itself would be subject to Nasdaq's current bid test. Mr. Jonathan G. Katz January 5, 2004 Page 3 disseminated in other small, less liquid securities in a manner that would allow for the use of the proposed uniform bid test, we recommend that the Commission apply the uniform test to those securities at that time. The Institute also supports the Commission's proposal to suspend the uniform bid test, on a two-year pilot basis, for a select group of highly liquid securities to be determined by the Commission. We believe that such stocks are far less likely to be susceptible to the forms of manipulative behavior that the short sale rule was designed to address. In addition, we believe a pilot program is an appropriate means for the Commission to examine the effects of relatively unrestricted short selling on, among other things, market volatility, price efficiency, and liquidity and to assess whether short sale regulation should be removed, in part or in whole, for actively traded securities. II.

**Exception from Uniform Bid Test** The Institute recommends that the Commission expand its current limited exemptive relief for VWAP transactions from the short sale rule. Currently, VWAP sale transactions are not subject to Exchange Act Rule 10a-1's tick test provided that the VWAP transaction is arranged before the market opens, the price is not determined until after the close of trading when the VWAP value is calculated, and other conditions are met. The Commission has proposed to codify this exemptive relief as part of Regulation SHO, subject to the same conditions included in the Commission's exemptive orders. While we support the Commission's proposal to include this exception to the uniform bid test, we recommend that the Commission broaden the exemption to include intra-day VWAP transactions. Specifically, we recommend that the Commission exempt a transaction based on a VWAP price over a minimum period of time sufficient to prevent the VWAP trade from

being used to place downward pressure on a stock (e.g., two hours). This exemption would enhance the ability of institutional investors to effectuate transactions based on partial-day VWAP prices and should not present the risks that the short sale rule was designed to address.

III. Uniform Locate Requirement In order to address problems associated with, among other things, “naked short selling,”<sup>6</sup> proposed Rule 203 of Regulation SHO would incorporate existing SRO affirmative determination or “locate” requirements into a uniform rule.<sup>7</sup> Proposed Rule 203 would be applicable to all equity securities, regardless of where they are traded, including Nasdaq SmallCap, OTCBB and Pink Sheet securities. Proposed Rule 203 also would impose additional requirements on securities that have failures to deliver in excess of a specified amount and on 6 Naked short selling occurs when someone is selling short without borrowing the necessary securities to make delivery. 7 In particular, proposed Rule 203 would prohibit a broker-dealer from executing a short sale order for its own account or the account of another person, unless the broker-dealer, or the person for whose account the short sale is executed: (1) borrowed the security, or entered into an arrangement for the borrowing of the security, or (2) had reasonable grounds to believe that it could borrow the security so that it would be capable of delivering the securities on the date delivery is due. Mr. Jonathan G. Katz January 5, 2004 Page 4 persons that, in connection with short sales, have failed to deliver securities for settlement within a specified time frame.<sup>8</sup> The Institute strongly supports the proposed uniform locate requirement. As the Commission notes in the Proposing Release, naked short selling, particularly in thinly- capitalized securities, can have a number of negative effects on the market, as it can be used as a means to deliberately depress the price of a security. The proposed uniform locate requirement should help prevent such manipulative short selling activity.

IV. Definition of Short Sale Currently, under Exchange Act Rule 3b-3, a person is considered “long” if he has purchased a security, or entered into an unconditional contract, binding on both parties, to purchase a security. Proposed Rule 200 of Regulation SHO would replace Rule 3b-3 and would require that a person not only have entered into an unconditional contract, binding on both parties, to purchase the security, but also that the contract specify the irrevocable price and amount of securities purchased and provide for present delivery in order for such person to have a “long” position with respect to the shares that are subject to the contract. The Institute supports the additional requirements of proposed Rule 200, in so far as they restrict certain activities designed to manipulate the market. Nevertheless, requiring that a contract specify an irrevocable price is in stark contrast to prevailing industry practice, where broker-dealers routinely consider themselves long when facilitating institutional investor block orders to sell at a VWAP or closing price. Adoption of this new requirement therefore could significantly affect the ability of broker-dealers to effect sales to facilitate an investor’s order to sell based on a VWAP or closing price and could act as a disincentive for broker-dealers to provide liquidity in handling block orders from institutional investors. The Institute therefore recommends that the Commission modify proposed Rule 200 to permit persons to consider themselves “long” for purposes of Regulation SHO if they have entered into an unconditional contract to purchase securities on a VWAP or closing price basis, provided that the contract specifies the amount of securities to be purchased.<sup>9</sup> While the specific price of the securities sold in a VWAP or closing price transaction will not be known when the contract is entered into, that price is nevertheless “fixed” at that time and is readily identifiable – either by reference to the published closing price in the case of closing price orders or by reference to the actual sales prices of the securities sold throughout the applicable time period in the case of a VWAP order. A broker-dealer agreeing to buy at a VWAP or closing price therefore would have an irrevocable contract at an objective, clearly discernable price. Moreover, we believe there is little risk that a facilitating broker-dealer would attempt to 8 In particular, for a security that exceeded the minimum threshold of failures, in the event of a failure to deliver by a broker-

dealer executing a short sale in that security by two days after the settlement date, the selling broker-dealer would be prohibited for ninety days from executing short sales for the person for whose account the failure to deliver occurred. During this ninety-day prohibition period, that person could engage in a short sale only where he or she borrowed the security, or entered into a bona fide arrangement to borrow the security, prior to the broker-dealer's execution of the short sale and actually delivered the securities on the settlement date. 9 We note that a contract involving the block facilitation by a broker-dealer of VWAP and closing price orders on behalf of clients also would clearly contemplate present delivery of the securities sold. Mr. Jonathan G. Katz January 5, 2004 Page 5 manipulate a VWAP or closing price to benefit its facilitation order – the supposed danger in allowing a long position based on a commitment to buy at these prices. \* \* \* \* \* The Institute appreciates the opportunity to provide comments on proposed Regulation SHO. If you have any questions regarding our comments, or would like any additional information, please contact me at (202) 371-5408. Sincerely, Ari Burstein Associate Counsel cc: Annette L. Nazareth, Director Robert L.D. Colby, Deputy Director Division of Market Regulation Paul F. Roye, Director Robert E. Plaze, Associate Director Division of Investment Management

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