

## COMMENT LETTER

May 18, 2009

# ICI Comment Letter Re: IOSCO Consultation Report on the Reg. of Short Selling

May 18, 2009 Mr. Greg Tanzer Secretary General IOSCO C / Oquendo 12 28006 Madrid Spain  
Re: IOSCO Consultation Report on the Regulation of Short Selling Dear Mr. Tanzer: The Investment Company Institute<sup>1</sup> is pleased to comment on the IOSCO consultation report on the regulation of short selling.<sup>2</sup> An efficient and effective trading environment is critical to funds and their shareholders.<sup>3</sup> The Institute therefore welcomes IOSCO's continuing interest in addressing issues that may impact the fair and orderly operation of the global securities markets and investor confidence in those markets. We share the view of many, including IOSCO, that short selling is an integral part of global capital markets, playing an important role in providing market liquidity and price discovery, as well as in investment strategies and risk management activities designed to enhance performance and maximize returns to investors. For this reason, we believe that legitimate and lawful short selling must be allowed

<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$9.71 trillion and serve over 93 million shareholders.

<sup>2</sup> Technical Committee of the International Organization of Securities Commissions, Consultation Report, Regulation of Short Selling, (March 2009) ("Consultation Report").

<sup>3</sup> As of year-end 2008, registered investment companies held 27% of outstanding U.S. issued stock, 44% of outstanding commercial paper, 33% of tax-exempt debt, 9% of U.S. corporate and foreign bonds and 15% of U.S. Treasury and government agency debt. See 2009 Investment Company Fact Book, 49th Edition, p. 11.

Mr. Greg Tanzer May 18, 2009 Page 2 of 8 to continue. We recognize, however, that it is possible for market participants to use short selling as a vehicle to illegally manipulate the prices of stocks or to facilitate other market abuses. Investors therefore deserve a careful examination of the issues surrounding short sales. To the extent that new or additional restrictions on short selling can increase investor confidence in the global securities markets, such restrictions should be carefully considered. Similarly, regulatory gaps that may lead to abuses related to short selling should be eliminated. In considering the regulation of short selling, however, regulators must balance the potential benefits of any rules against their costs as well as carefully consider any unintended consequences of regulation for investors, such as reducing the liquidity or price discovery benefits of short selling.<sup>4</sup> We agree, in general, with the four principles set forth in the Consultation Report for the effective regulation of short selling:

(1) short selling should be subject to appropriate controls to reduce or minimize the potential risks that could affect the orderly and efficient functioning and stability of financial markets; (2) short selling should be subject to a reporting regime that provides timely information to the market or to market authorities; (3) short selling should be subject to an effective compliance and enforcement system; and (4) short selling regulation should allow appropriate exceptions for certain types of transactions for efficient market functioning and development. These principles can be a useful tool for regulators as they develop new or additional short selling regulations. The U.S. Securities and Exchange Commission ("SEC") already has in place several regulations relating to these principles and is currently examining several others. Below are the Institute's specific comments on each of the principles. I. The First Principle: Short selling should be subject to appropriate controls to reduce or minimize the potential risks that could affect the orderly and efficient functioning and stability of financial markets The Institute believes that short selling, as with any other type of trading, should be subject to appropriate controls to minimize any potential risks it could have on the orderly and efficient functioning and stability of the securities markets. The Institute continues to examine various proposals being discussed to address concerns relating to short selling including regulations relating to the settlement of short selling transactions, proposed price restrictions or circuit breaker restrictions on short selling, and bans on short selling.

4 Earlier this year, the Institute issued a joint statement with the Investment Management Association (UK) and the Investment and Financial Services Association (Australia) to reaffirm the support of prudent regulatory oversight of short selling and recommend a sensible global response to regulatory reform in this area. Industry statement from ICI (USA), IMA (UK) and IFSA (Australia), dated January 6, 2009. Mr. Greg Tanzer May 18, 2009 Page 3 of 8 A.

Settlement of Short Selling Transactions The Institute agrees with the Technical Committee that having an effective discipline for the settlement of short selling transactions is an important component of an effective short selling regulatory regime. The Institute strongly supports efforts in this area by the SEC in the United States to develop an effective discipline for short selling. Most significantly, we supported the SEC's rule which inhibits abusive "naked" short selling through a requirement that securities be purchased or borrowed to close out any fail to deliver position.<sup>5</sup> By all accounts, the SEC's rule has made great strides in this area, particularly in efforts to reduce fails to deliver.<sup>6</sup> We would encourage other regulators to examine implementing similar rules.<sup>7</sup> B. Price Test

Restrictions, Circuit Breaker Restrictions and Short Sale Bans The Consultation Report notes that in mitigating the risks associated with short selling, market authorities have at their disposal several tools to exercise various levels of controls at different parts of the short selling transaction chain. As the Technical Committee recognizes, actions have varied among global securities regulators. Some jurisdictions have adopted controls that restrict short selling, while others permit short selling but have other measures designed to counter the risks of short selling. The SEC recently published for comment a proposal containing several approaches to restrictions on short selling.<sup>8</sup> One approach would apply a price test restriction on a market wide and permanent basis. Another approach would apply a circuit breaker restriction only to a particular security during a specified market decline in that security. The SEC also proposed an alternative

5 See Letter from Heather Traeger, Assistant Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, U.S. Securities and Exchange Commission, dated December 16, 2008. Specifically, the rule 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. Broker-dealers in violation of this "close-out" requirement are prohibited from further short sales in the same

security unless the shares are located and pre-borrowed. 6 See U.S. Securities and Exchange Commission, Memorandum from the Office of Economic Analysis regarding Impact of Recent SHO Rule Changes on Fails to Deliver (April 16, 2009). 7 In our comment letter to the SEC, we also discussed potential unintended consequences of the rule on the securities lending market. For example, despite efforts in the rule to clarify issues relating to the close out of a fail to deliver position for a long sale of equity securities, the timing and close-out requirements of the rule have the potential to create disincentives for holders of long positions to lend their securities. In light of these concerns, we encourage regulators to review fully the implications of rules in this area and to address any unintended consequences for, or impediments to, the effective operation of the securities lending markets. 8 SEC Release No. 59748 (April 10, 2009), 74 FR 18042 (April 20, 2009). Mr. Greg Tanzer May 18, 2009 Page 4 of 8 “circuit breaker halt rule” that would prohibit any person from selling short a particular security, wherever it is traded, while the circuit breaker is in effect. The Institute continues to examine the possible impact of the proposal and will provide detailed comments to the SEC next month.<sup>9</sup> We believe, however, that no matter what course of action the SEC determines to take, it must proceed deliberately as it considers the consequences of the proposal for investors and must ensure that it does not negatively impact investors by, for example, reducing market liquidity or harming price discovery. It also must balance the potential benefits of the proposed rules against their costs. We would urge other regulators to also examine these considerations as they consider similar regulations of, and restrictions on, short selling. II. Second Principle: Short selling should be subject to a reporting regime that provides timely information to the market or to market authorities The Institute supports the concept of enhanced and meaningful reporting of short selling and has been closely following developments in the U.S. and abroad relating to disclosure of short selling information to both regulators and the public. We appreciate that the Technical Committee stated that while, in general, regulators should aim to promote appropriate transparency of short selling information to the market, it recognizes that there are a number of considerations, including that information on short selling may mislead the market and that excessive transparency could result in a reduction of the benefits that short selling brings to the markets. We agree with the Technical Committee that market authorities, in structuring a reporting and transparency regime, should take into account these considerations. In general, the Institute believes that regulators should have both the information and capability to monitor and investigate thoroughly any market manipulation or abuse. We therefore support timely disclosure directly to the market regulator of short sale positions above a de minimis amount. It is essential, however, that any short selling regulatory regime adequately protects confidentiality of the data provided to regulators. We are therefore opposed to public disclosure of short selling information. A. Confidentiality Must be Provided to Short Selling Information Provided by Investors Information about investors’ short selling provided to regulators in the United States currently is non-public. The SEC determined to maintain the confidentiality of this information after the Institute, and other market participants, expressed serious concerns with its original determination to

<sup>9</sup> Comments on the proposal are due to the SEC by June 19, 2009. We will forward a copy of our comments on the proposal to the Technical Committee at that time. Mr. Greg Tanzer May 18, 2009 Page 5 of 8 make the information provided by institutional investors regarding short selling publicly available.<sup>10</sup> Most significantly, we expressed concerns that public disclosure of this information may lead to frontrunning of fund trades. We expanded upon our views in a recent comment letter to the SEC<sup>11</sup> on its rule requiring institutional investment managers to report to the SEC certain information concerning their short sales and short positions.<sup>12</sup> In that letter, we stated that it is critical that the SEC balance its obligation to protect the markets from abusive short

selling with the burdens imposed on market participants by the disclosure requirements and the potential unintended consequences of those requirements. Most significantly, we urged the SEC to retain the portion of the rule that makes the information submitted under the rule's disclosure requirements nonpublic. The Institute strongly urges regulators worldwide to maintain or adopt the nonpublic status of the information provided to them regarding short selling and short positions. Making public the information filed by investment managers may lead to frontrunning of fund trades, a longstanding concern for funds. In addition, allowing for public disclosure of the information may confuse investors and other market participants about an investment manager's intentions. Finally, public disclosure of the information could result in increased shorting of certain stocks as other market participants imitate firms' publicized short positions. We believe that if any public disclosure regime is to be established, this is best achieved by a market or regulator publishing a single aggregated net short-interest position for each stock on a periodic, but sufficiently delayed, basis.

**B. Timing for Providing Information to Regulators** The Institute believes that the timing for providing short selling information to regulators must balance the regulators' need to monitor short sale activity with the costs and burdens of producing this

10 See Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to Christopher Cox, Chairman, U.S. Securities and Exchange Commission, dated September 19, 2008. See also Letters from Paul Schott Stevens, President, Investment Company Institute, to Christopher Cox, Chairman, Securities and Exchange Commission, dated September 14, 2005 and August 29, 2006 (expressing concerns regarding the frontrunning of fund trading information).

11 See Letter from Ari Burstein, Senior Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, U.S. Securities and Exchange Commission, dated December 16, 2008.

12 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). Specifically, institutional investment managers that exercise investment discretion with respect to certain accounts holding securities described under the Securities Exchange Act of 1934 that have an aggregate fair market value of at least \$100,000,000, and effect short sales of those securities, generally are required to file information with the SEC on a weekly basis. Mr. Greg Tanzer May 18, 2009 Page 6 of 8 information. In the United States, institutional investors are required to file the requisite information with regulators on a weekly basis, which we believe may be more frequent than necessary to achieve regulatory goals. We recommend that regulators provide a reasonable amount of time in which to file information regarding short selling. In our recent comment letter to the SEC, we recommended that this information be filed on a time period similar to the reporting requirements for long positions in the United States, i.e., 45 days after the end of each quarter. In the Institute's view, such a time period would not lessen a regulator's ability to monitor for manipulative short selling and would alleviate concerns expressed by investment managers that do not operate on one global system or that must aggregate across affiliates.

13 **C. Limit the Reportable Information to Short Positions** Several jurisdictions' rules, including those in the United States, require managers to report short sales and short positions. We recommend that regulators require only the disclosure of short positions. We believe regulators would obtain the information they need to evaluate any significant market impact of short selling activity through collection of short position information only. Limiting the scope of the reporting requirement to short positions also would balance the needs of regulators to protect the marketplace with the high costs of developing and operating new systems to collect, compile and provide regulators with data that is not otherwise captured by investment managers. Finally, limiting the reporting to short positions would create operational efficiencies because any new system could be designed to work in conjunction with existing systems for reporting long positions in the

United States. III. The Third Principle: Short selling should be subject to an effective compliance and enforcement system The Institute strongly supports a robust enforcement regime to accompany the regulation of short sales. As the Consultation Report notes, this includes a regulator having comprehensive inspection, investigation and surveillance powers; comprehensive enforcement powers; and a regulatory system that ensures an effective and credible use of these powers and implementation of an effective compliance program. A robust inspection and enforcement regime is critical to investors, providing them with confidence that violations or abuses of short sale regulations will be detected and punished. As

13 In addition to concerns relating to the confidentiality of information and the timing of disclosure of the information, our letter sets forth several recommendations to address concerns relating to aggregation requirements under the rule and expanding exceptions to the rule's reporting requirements. Specifically, we believe there must be appropriate exemptions based on the percent of the class of securities issued by the issuer and the fair market value of these short positions, i.e., thresholds that are high enough to ensure that regulations capture only significant short positions. Mr. Greg Tanzer May 18, 2009 Page 7 of 8 discussed above, we support the reporting by investors of appropriate information to regulators to help detect any potential abusive trading practices and to facilitate an effective compliance and enforcement system. IV. The Fourth Principle: Short selling regulation should allow appropriate exceptions for certain types of transactions for efficient market functioning and development The Institute agrees with the Technical Committee that flexibility in short selling regulation is key to an effective short selling regulatory regime. We therefore support regulators creating appropriate exceptions to any short selling rules. The SEC's outstanding proposals contain several exceptions that are of critical importance to the operation of the proposed rules. Only with these exceptions can any unintended consequences of the proposed short sale restrictions on market liquidity, efficiency and price discovery be minimized. Such exceptions also allow for flexibility by market participants in short selling activities that are critical to the efficient functioning of capital markets. V. Ensure Cooperation of Regulators in All Jurisdictions As regulators examine their current, and consider future, initiatives relating to short sales, we strongly support the coordination by regulators to ensure sensible cross-border regulations in this area. As the Consultation Report notes, regulators in several foreign jurisdictions have already adopted rules regarding short sales. At the moment, however, these rules are not consistent and in many jurisdictions, the rules' provisions, particularly those relating to public disclosure of investment managers' short sales and positions, generate significant concerns for institutional investors, particularly relating to frontrunning. Other provisions of these rules create operational and cost burdens for investors. Many of our members operate with interconnected trading desks in several locations around the world. Our increasingly global markets therefore demand cooperation among regulators as fund managers pursue an increasing cross-border presence in the interest of shareholders. \* \* \* \* \* We look forward to working with IOSCO as it continues to examine these issues. In the meantime, if you have any questions, please feel free to contact me directly at (202) 371-5408 or Heather Traeger at (202) 326-5920. Sincerely, /s/ Ari Burstein Ari Burstein Senior Counsel Mr. Greg Tanzer May 18, 2009 Page 8 of 8 cc: The Honorable Mary L. Schapiro The Honorable Kathleen L. Casey The Honorable Elisse B. Walter The Honorable Luis A. Aguilar The Honorable Troy A. Paredes James Brigagliano, Acting Co-Director Dan Gallagher, Acting Co-Director Division of Trading and Markets U.S. Securities and Exchange Commission

should not be considered a substitute for, legal advice.