

## COMMENT LETTER

February 12, 2007

# Institute Letter on SEC Rule Proposals Relating to Short Selling (pdf)

February 12, 2007 Nancy M. Morris Secretary U.S. Securities and Exchange Commission  
100 F Street, N.E. Washington, D.C. 20549-1090 Re: Short Selling in Connection With a Public Offering (File No. S7-20-06) Dear Ms. Morris: The Investment Company Institute<sup>1</sup> supports the Commission's efforts to further safeguard price integrity in the offering process and to protect issuers from manipulative activity by proposing amendments to Rule 105 of Regulation M.<sup>2</sup> While the Institute supports the goals of the proposal, we are concerned that the proposal could result in inadvertent violations by investment companies<sup>3</sup> of Rule 105. Accordingly, we recommend that the Commission clarify the scope of the term "person" under Rule 105, as discussed more fully below. Short Selling in Connection With a Public Offering Currently, Rule 105 of Regulation M prohibits a person from covering a short sale with securities sold in an offering if such person sold short within five days prior to the pricing of the offering or the period beginning with the filing of the registration statement and ending with pricing, whichever is shorter (the "five-day period"). To address efforts to evade the prohibitions of Rule 105, the proposal would instead make it unlawful for a person to effect a short sale during the five-day period and then purchase the security in an offering. The Institute is concerned that the proposal could, without further clarification and refinement, result in inadvertent violations of Rule 105 by funds. Our concerns arise from the 1 The Investment Company Institute is the national association of the U.S. investment company industry. More information about the Institute is included at the end of this letter. 2 SEC Release No. 34-54888 (December 6, 2006), 71 FR 75002 (December 13, 2006). 3 For purposes of this letter, the term "fund" refers to an investment company registered under the Investment Company Act of 1940. Nancy M. Morris February 12, 2007 Page 2 of 4 application of the proposed rule to any "person."<sup>4</sup> Specifically, it is unclear whether a "person" for purposes of Rule 105 would include each fund within a complex (or each series of a fund)<sup>5</sup> or each subadvised portion of a single fund.<sup>6</sup> If a "person" is deemed to include all funds within a fund complex, all series of a fund, or collectively all the portions of a particular fund that has multiple subadvisers, the proposal could create difficulties for funds effecting transactions in securities that are the subject of an offering. For example, if one fund within a fund complex (or a series of a fund) effects a short sale during the five-day period and another fund in the same complex (or another series of a fund) purchases the security in the offering, these funds (or series) would violate Rule 105 if all funds in a fund complex are considered one "person." Similarly, if a subadviser to a fund enters into a short sale in a security during the five-day period prior to an offering, and a separate subadviser to the same fund purchases the security in the offering, the fund would be in violation of Rule 105 if both subadvised portions of the fund are considered one "person" under the rule. Because the subadvisers are required to be

contractually prohibited from consulting with each other in order to comply with certain exemptive rules under the Investment Company Act,<sup>7</sup> the subadvisers could not readily avoid this violation. 4 Section 3(a)(9) of the Exchange Act defines a “person” for purposes of Rule 105 of Regulation M. Under Section 3(a)(9), a person is defined to include, among other things, a natural person or a company. Similarly, Section 2(a)(28) of the Investment Company Act of 1940 defines a person to mean a natural person or a company and Section 2(a)(2) of the Securities Act defines a “person” to mean, among other things, an individual, a corporation, a partnership, an association, a joint-stock company, a trust, or any unincorporated organization. 5 Many funds, especially open-end funds (or “mutual funds”), are organized using a multiple series structure. A series fund consists of a single legal entity (typically organized as a Delaware statutory trust, a Massachusetts business trust or a Maryland corporation) with multiple series of shares. Each series has a portfolio of investment assets allocated to it, and the series is preferred over all other series with respect to its allocated assets. Each series typically operates, for investment purposes, as a separate fund, and a “mutual fund” generally is understood to refer to a particular series and its related portfolio, rather than to the fund that is the legal entity. The Commission, through several exemptive rules and in various no-action and interpretive positions, has recognized that a series is the functional equivalent of a separate fund in applying the various limitations and restrictions imposed by the Investment Company Act and the rules thereunder. 6 Some funds, including some mutual funds that are organized as series, are managed by multiple managers or subadvisers. Under these arrangements, each subadviser will manage a portion of the fund’s portfolio and generally is unable to influence investment decisions made on behalf of the portion of the fund that it does not advise. 7 See Transactions of Investment Companies with Portfolio and Subadviser Affiliates, SEC Release No. IC-25888 (January 14, 2003), 68 FR 3142 (January 22, 2003) (adopting amendments to Investment Company Act Rules 10f-3, 12d3-1, 17a- 10, and 17e-1). These exemptions, which expand the circumstances in which a fund may engage in transactions with persons that subadvise a portion of the fund’s assets, generally are contingent on two requirements - the subadviser may not be an affiliated person of an investment adviser responsible for providing advice with respect to the portion of the fund that is the subject of the transaction, and the advisory contracts of the relevant subadvisers must prohibit them from consulting with each other concerning transactions for the fund in securities or other assets and must limit the subadvisers’ responsibility to providing advice to a discrete portion of the fund’s portfolio. Nancy M. Morris February 12, 2007 Page 3 of 4 These types of transactions do not raise the concerns that are the subject of, and are not the type of conduct that was the impetus for, the proposal. In addition, effectively preventing the participation by funds in an offering (or preventing funds from entering into short sales) in the situations discussed above seems counter to the purpose of the proposed amendments - to permit activity that does not interfere with independent market dynamics prior to an offering. Accordingly, to prevent any unintended consequences for funds, the Institute recommends that the Commission clarify that each individual fund within a fund complex (and each series of a fund), and each subadvised portion of a particular fund, is a separate “person” for purposes of Rule 105. Such guidance would be consistent with exemptive rules under the Investment Company Act, will prevent inadvertent violations of Rule 105 by funds, and will preserve the protections and goals of the amendments to Regulation M.<sup>8</sup> \* \* \* \* \*

\* \* \* The Institute appreciates the opportunity to comment on this proposal. If you have any questions about our comments or would like any additional information, please contact me at 202-371-5408. Sincerely, /s/ Ari Burstein Ari Burstein Senior Counsel cc: Erik R. Sirri, Director James A. Brigagliano, Associate Director Division of Market Regulation Andrew Donohue, Director Division of Investment Management \* \* \* \* \*

<sup>8</sup> To the extent the Commission does not make our recommended clarifications, the Institute recommends that

the Commission consider extending the aggregation unit concept set forth in Rule 200(f) of Regulation SHO to funds. The aggregation unit concept allows registered broker-dealers to treat independent trading units separately for determining when the trading unit is net long or net short a security. Nancy M. Morris February 12, 2007 Page 4 of 4 About the Investment Company Institute ICI members include 8,795 open-end investment companies (mutual funds), 658 closed-end investment companies, 325 exchange-traded funds, and 4 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately \$10.279 trillion (representing 98 percent of all assets of US mutual funds); these funds serve approximately 93.9 million shareholders in more than 53.8 million households.

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