INVESTMENT COMPANY INSTITUTE

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May 20, 2008

Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Proposed Anti-Fraud Short Sale Rule (File No. S7-08-08)

Dear Ms. Morris:

The Investment Company Institute[1] supports the Commission's continuing efforts to address abuses involving short selling and the related harmful effects of abusive short selling on the securities markets.[2] The proposed rule, Rule 10b-21 under the Securities Exchange Act of 1934, would further these efforts by making particular activities of a seller involving "naked" short selling (*i.e.,* selling short without borrowing the necessary securities to make delivery) an anti-fraud violation under the federal securities laws.[3] While we strongly support the intent of the proposed rule, as discussed in further detail below, we recommend that the Commission clarify several issues relating to the proposal prior to its adoption.

Proposed Rule 10b-21

Proposed Rule 10b-21 is narrowly tailored to address situations associated with abusive naked short selling. Specifically, the proposed rule would make it an anti-fraud violation for a short seller to

[1] 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 $12.31 trillion and serve almost 90 million shareholders.

[2] The Institute has strongly supported past Commission efforts in this area. *See, e.g.,* Letter to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, from Ari Burstein, Associate Counsel, Investment Company Institute, dated January 5, 2004.

[3] *See* Securities Exchange Act Release No. 57511 (March 17, 2008), 73 FR 15375 (March 21, 2008) ("Proposing Release").

deceive a broker-dealer about its intention or ability to deliver securities timely for settlement, including a deception about the source of borrowable shares available to that seller to cover a short sale. The proposed rule also would address situations where sellers misrepresent to their broker-dealers that they own the securities being sold. A violation of the proposed rule only would occur if there were both a failure to deliver the securities and the seller possessed the requisite scienter.

Scienter and Delivery Requirements

The Institute strongly supports the scienter requirement of the proposed rule. We believe this requirement is critical to avoid treating inadvertent temporary fails to deliver as violations of the proposed rule. For example, many mutual funds rely on automated systems to identify the location of a security. On occasion, however, an error related to these systems may occur, resulting in a failure to timely deliver a security. In this instance, the fund would not have deliberately misrepresented its intention or ability to deliver the security by settlement date and, a settlement, albeit late, would still occur. The scienter requirement would ensure that such unintentional and non-abusive examples of short selling would not fall within the scope of the rule.

The Proposing Release also requests comment on whether the failure to deliver the security on or before the date delivery is due should continue to be included as a required element of a violation of proposed Rule 10b-21. We believe that the delivery requirement is unnecessary if the proposed scienter requirement is adopted. The proposed rule is designed to target deceptive conduct in connection with a seller's intention or ability to deliver securities timely for settlement. 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. Thus, the inclusion of a failure to deliver requirement in the proposed rule, in addition to a scienter requirement, is unnecessary and possibly counterproductive. Instead, we believe that the failure to deliver the security on or before the date delivery is due should be a factor in determining whether the necessary scienter was present for establishing a violation of the proposed rule.

Locate Requirement

The Proposing Release states that the proposed rule is designed to aid broker-dealers in complying with the locate requirement of Regulation SHO[4] by holding responsible short sellers who deceive a broker-dealer about a locate, *e.g.*, the source, ownership or ability to deliver shares. While the Institute supports this change, which is intended to target unscrupulous short sellers, we recommend 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 potential costs of

[4] The locate requirement of Regulation SHO states that a broker-dealer may not accept a short sale order from another person, or effect a short sale for its own account, unless the broker-dealer has: (1) borrowed the security, or entered into a bona-fide arrangement to borrow the security; or (2) reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due; and (3) documented compliance with this requirement.

the alternative, *i.e.,* 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.[5]

The Institute 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 Rule 200(b) of Regulation SHO.[6] The proposed rule is designed to encourage all sellers to timely deliver, or arrange for delivery of, securities to a buyer. The fact that the seller owns the securities is the pertinent representation that should be made, not the source of the securities' ownership. As long as the seller's disclosure that it is deemed to own the securities can be relied upon by the broker handling its sell orders, there is no reason to force a seller to disclose any additional information.

Finally, if the Commission proceeds with the adoption of proposed Rule 10b-21, then the Institute recommends that the Commission 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.[7] The long marking proposal raises a number of concerns relating to systems and costs. Specifically, under the proposal, institutional investors would have to implement systems to track positions across multiple custodians to facilitate the communication of information to a broker-dealer – all prior to a broker-dealer entering a sell order. The purpose of the long marking proposal was to address issues relating to abusive short selling. If proposed Rule 10b-21 is adopted, there is no reason to proceed with the proposal in light of the provision in proposed Rule 10b-21 covering intentional misrepresentations regarding the ownership of shares being sold.

Application of the Proposed Rule to ETFs

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[5] For example, without the ability to rely on customer assurances, broker-dealers may require their customers to develop new systems to link to each prime broker and each executing broker to fulfill the requirements of the proposed rule. The costs of developing these systems could be particularly onerous for customers given the universe of securities affected by the proposed rule, *i.e.,* on an average day, only approximately one percent (by dollar value) of all trades fail to settle on time, and some of these fails are for reasons other than short sales.

[6] Rule 200(b) of Regulation SHO provides that a seller is deemed to own a security if, (1) the person or his agent has title to it; or (2) the person has purchased, or has entered into an unconditional contract, binding on both parties, to purchase it, but has not yet received it; or (3) the person owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange; or (4) the person has an option to purchase or acquire it and has exercised such option; or (5) the person has rights or warrants to subscribe to it and has exercised such rights or warrants; or (6) the person holds a security futures contract to purchase it and has received notice that the position will by physically settled and is irrevocably bound to receive the underlying security.

[7] *See* Securities Exchange Act Release No. 56213 (August 7, 2007), 72 FR 45558 (August 14, 2007) (the "long marking proposal").

The Proposing Release requests comment on whether the proposed rule should apply to ETFs. The Institute believes that, given the unique structure and operation of ETFs, if the proposed rule will apply to such funds, several aspects of the application of the rule, particularly to the ETF creation and redemption process, must be clarified.

Specifically, there are several circumstances where entities included in the creation and redemption process may be in technical violation of the proposed rule solely because of the manner in which ETF shares are created. For example, if the proposed rule is applied to the creation and redemption process, it is unclear how the scienter requirement would be applied. When issuing ETF creation units, it is not uncommon for delivery of the underlying securities in an ETF basket to miss settlement, *i.e.,* some of the securities may fail to deliver. In anticipation of such a failure, an Authorized Participant[8] may enter into an agreement with an ETF sponsor to provide it with collateral equal to the value of the securities that the Authorized Participant did not deliver, plus a certain percentage (*e.g.,* 3 to 5 percent) to cover any movement in the market during the period between the Authorized Participant's failure to deliver and successful delivery. While the Authorized Participant knows it will be unable to deliver the security, by seeking the ETF sponsor's permission to provide collateral until delivery can be accomplished, the Authorized Participant had no intention of deceiving the ETF sponsor.[9]

The Institute doubts that this is the type of situation that the proposed rule intended to cover. We therefore recommend that the Commission clarify the application of the proposed rule to ETFs prior to its adoption. The Institute is pleased to offer its assistance to the Commission as it examines these issues.

Enforcement of Short Selling Rules

As discussed in the Proposing Release, naked short selling as part of a manipulative scheme is already illegal under the general anti-fraud provisions of the federal securities laws, including Rule 10b-5 under the Securities Exchange Act of 1934. Existing enforcement powers available to the Commission in this area therefore would overlap to a certain extent with those provided under proposed Rule 10b-21. As the Commission notes, however, proposed Rule 10b-21 would differ from existing rules by highlighting the specific liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement.

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[8] An Authorized Participant is a participant in an institutional clearing system that has entered into an agreement with the ETF or its distributor authorizing it to transact directly with the ETF.

[9] This course of action provides protection for the ETF sponsor and allows the sponsor to use the collateral to purchase the underlying security in the event the Authorized Participant continues to fail to deliver.

While the Institute does not support "rulemaking for the sake of rulemaking" and, in general, encourages the Commission to eliminate duplicative and overlapping rules and regulations, we recognize 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. Nevertheless, if the Commission is to adopt a rule providing additional enforcement powers in this area, these increased powers will prove ineffective in eliminating abusive naked short selling absent a robust and sustained enforcement program. Despite the Commission's recent record of rulemaking and enforcement cases in this area,[10] it is our understanding that incidents of abusive naked short selling still take place, to the detriment of investors in the securities markets. We therefore urge the Commission to utilize all of its available enforcement powers aggressively and to vigorously enforce its rules related to the elimination of short selling abuses.

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We appreciate the opportunity to comment on the proposal. If you have any questions regarding our comments or need additional information, please contact Ari Burstein, Senior Counsel, at (202) 371-5408 or the undersigned at (202) 326-5920.

Sincerely,

/s/ Heather Traeger

Heather Traeger
Assistant Counsel

cc: Erik Sirri, Director
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[10] *See, e.g.,* SEC Litigation Release No. 20537 (April 24, 2008), *SEC v. Paul S. Berliner*, Civil Action No. 08-CV-3859 (JES) (S.D.N.Y.).