MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

May 21, 2008

Via Electronic Mail: rule-comments@sec.gov

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Proposed Naked Short Selling Antifraud Rule; S7-08-08

Dear Ms. Morris:

Managed Funds Association ("MFA")[1] appreciates the opportunity to comment on the Securities and Exchange Commission's ("SEC" or "Commission") proposed naked short selling antifraud rule (the "Proposed Rule") under the Securities Exchange Act of 1934 (the "Exchange Act"), issued in Release No. 34-57511 (the "Release").

I. Introduction

MFA fully supports the Commission's efforts to combat naked short selling and other market abuses. Market manipulation, such as intentional and abusive naked short selling, undermines the integrity of the U.S. capital markets and threatens investor confidence, market liquidity and market efficiency. MFA commends the Commission for its work in adopting Regulation SHO to address the problems of naked short selling and extended fails to deliver. Regulation SHO has simplified and streamlined the procedures for all short sellers to locate securities for borrowing and significantly reduced the average daily number of fails to deliver.[2] We believe the locate requirement has also had a strong impact discouraging naked short selling. MFA also supports the Commission's efforts to prosecute fraud. We are concerned, however, that the Proposed Rule may have the unintended consequence of deterring legitimate short selling.

MFA regards short selling as an essential method by which investors, including fiduciaries managing others' assets, can manage risk, hedge their portfolios, and reflect their view that the

[1] MFA is the voice of the global alternative investment industry. Our members include professionals in hedge funds, funds of funds and managed futures funds. Established in 1991, MFA is the primary source of information for policymakers and the media and the leading advocate for sound business practices and industry growth. MFA members represent the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $2 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

[2] Fails to Deliver Pre- and Post-Regulation SHO, Office of Economic Analysis, SEC (Aug. 21, 2006) *available at* http://www.sec.gov/spotlight/failstodeliver082106.pdf (providing that the average daily aggregate fails to deliver declined by 34% after the effective date of Regulation SHO).

current market price of a security is higher than it should be. The benefits of short selling to the broader market are well known.[3] Short selling provides liquidity to the market and makes markets more efficient.

We believe that the Proposed Rule, as constructed, is unnecessary and overbroad. The impetus for the proposal is the Commission's concern with abusive naked short selling, which involves an intentional failure to deliver securities within the standard settlement timeframe. As noted by leading scholars from academia and industry at the SEC's Roundtable on the Regulation SHO Pilot,[4] however, there is no persuasive evidence that short selling in general is more frequently abusive than other types of transactions. Indeed, manipulative purchases—for example, so-called pump-and-dump schemes, appear to be far more common than abusive short sales. Historically, there have been far more market manipulation enforcement cases against pump-and-dump boiler room operations than short sellers. Thus, we question the need to single out naked short selling from other transaction types.

The Release states that the purpose of the Proposed Rule is to highlight the specific liability of persons that deceive specified persons about their intention or ability to deliver securities in time for settlement. We question the necessity of the Proposed Rule, since the Commission acknowledges that it already has ample authority to prosecute persons who engage in abusive naked short selling and fraudulent misrepresentations in connection with sales of securities. Rather than adopting an entirely new rule that will raise a host of interpretive issues (some of which are discussed below), the Commission can highlight the liability of persons who engage in deception in connection with securities sales by issuing a notice or statement of policy that it will pursue such cases under its existing antifraud authority, including Section 17(a) of the Securities Act of 1933, and Sections 10(b) and 15(c) of the Exchange Act and rules 10b-5 and 15c1-2 thereunder.

The Release cites no data to support the need for this rule, and cites only three cases over a 29-year span. We do not believe that this record supports the adoption of the Proposed Rule. In light of the comprehensive set of short sale regulations the Commission has implemented, additional operational procedures implemented by broker-dealers to achieve compliance with Regulation SHO, and broad antifraud authority under existing statutes and rules, we believe the Commission should instead focus on the enforcement of existing regulations to prosecute naked short selling.

Nevertheless, if the Commission deems it appropriate and necessary to promulgate a naked short selling antifraud rule, we urge the Commission to carefully consider the potential unintended

[3] *See*, e.g., Arturo Bris, William N. Goetzmann and Ning Zhu, "Efficiency and the Bear: Short Sales and Markets Around the World" (Yale School of Management, Jan. 2003), a study of forty-seven stock markets around the world, in which the authors found that markets with active short sellers reacted to information more quickly and set prices more accurately; and Owen A. Lamont, "Go Down Fighting: Short Sellers vs. Firms", available at http://www.som.yale.edu/faculty/oa14/research/go%20down%20fighting.pdf (concluding that constraints on short selling as a result of various actions taken by firms allow stocks to be overpriced and that firms taking anti-shorting actions have in subsequent year abnormally low returns of about minus two percent per month).

[4] SEC Roundtable on the Regulation SHO Pilot (Sept. 15, 2006) *webcast at* www.connectlive.com/events/secshoroundtable/.

consequences of the Proposed Rule. Short selling plays a significant economic function in our markets and counterbalances pressures that cause a stock to be overpriced. We hope the Commission will recognize the benefits of short selling in a final rule release and assure market participants that a naked short selling antifraud rule is not meant to deter legitimate short selling.

II. Comments

A. Unintended Consequences

MFA commends the Commission for the short sale regulatory approach taken in Regulation SHO and believes the Commission achieved the right balance between guarding against short selling abuses and regulating in a manner that would not impede liquidity and the ability of market participants to establish short positions. As a result, the number of failures to deliver on an average day is exceptionally low—less than 1% of the dollar amount of total daily trading.[5] MFA is concerned, however, that the Proposed Rule would have the unintended consequence of reversing some of Regulation SHO's achievements by deterring legitimate short selling, impeding liquidity, and negatively impacting best execution.

The Release states that scienter would be a necessary element for a violation of Rule 10b-21. The Release also indicates that the Commission would follow the views of the federal appellate courts that have concluded that scienter may be established by a showing of knowing conduct or by "an extreme departure from the standards of ordinary care" (the latter is often referred to as "recklessness"). Recklessness is a much more subjective standard and we are concerned that honest mistakes could be re-characterized as reckless conduct with the benefit of 20/20 hindsight. As a result, a recklessness standard for liability could have an unwarranted and counterproductive chilling effect on short selling.

In particular, we are concerned that a person who fails to deliver a security on or before the date delivery is due as a result of an operational shortcoming could be alleged to have been reckless in representing that she had a good locate or was long the security, even where there was no intent to deceive anyone. There are many instances where such failures to deliver may arise. For example:

> Scenario 1: A seller obtains a locate for a "hard to borrow" security, but the source is unable to deliver securities at settlement.
>
> Scenario 2: A seller experiences a systems malfunction which results in a failure to locate or an inaccurate locate, unbeknownst to the seller.

In each instance, even if the seller could argue that she did not intentionally deceive any of the persons covered by the Proposed Rule, the seller might be subject to claims that the seller was reckless because she did not exercise sufficient care before making her representations in

[5] SEC Open Meeting discussing Proposed Naked Short Selling Antifraud Rule (Mar. 4, 2008) *webcast at* www.connectlive.com/events/secopenmeetings/.

connection with the sale.[6] The fear that operational failures could potentially subject sellers to antifraud allegations would have a negative impact on short selling. The Proposed Rule also could impede liquidity if broker-dealers tighten their securities lending standards out of a concern about increased legal liability (discussed further below). Similarly, if stricter security lending standards and recordkeeping requirements are implemented, we are concerned that trade execution quality will suffer to the detriment of investment management clients.

We believe that a narrowly tailored rule requiring a finding of intentional deception will best achieve the Commission's objective without deterring legitimate short selling. Requiring a finding of specific intent, rather than recklessness, is particularly appropriate given that the Commission's ultimate goal in proposing Rule 10b-21 is to prevent market manipulation. The anti-manipulation provisions of Section 9 of the Act generally require a showing of specific intent.[7] MFA recommends that a finding of knowing conduct and not recklessness be required for a violation of a naked short selling antifraud rule.

B. Private Right of Action

Although the Release is silent on the matter, at the March 4, 2008 Commission open meeting, Commission staff stated that there would be a private right of action under the Proposed Rule. We are concerned that a private right of action under the Proposed Rule would subject sellers to frivolous, unwarranted, and expensive litigation, and could further deter legitimate short selling. This is particularly the case if recklessness, as discussed above, could serve as a basis for a private right of action for violation of the rule.

There is a great deal of public confusion and misunderstanding about failures to deliver. As noted by the Commission and its staff, failures to deliver can arise from a variety of causes, many of which are not problematic.[8] Nevertheless, we are concerned that members of the public often incorrectly presume that unlawful conduct has taken place whenever there is a failure to deliver securities and may bring lawsuits (including strike suits) under the Proposed Rule on that basis.

The United States has become an increasingly litigious society and a private right of action under the Proposed Rule would further open the door to more litigation and raise the costs of doing business. Such a right would provide another avenue for issuers whose securities have been heavily shorted to retaliate against short sellers.[9] Broker-dealers would also be subject to further

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[6] We appreciate the guidance in the Release about the use of "Easy to Borrow" lists in connection with short sales, and about long sales from a margin account where the broker-dealer has loaned out the shares. However, these examples illustrate the numerous interpretive questions that the Proposed Rule raises.

[7] *See, e.g.,* Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (1969, CA2 NY), *and* In Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341 (1973, CA2 NY).

[8] SEC Release 34-50103 (July 28, 2004), 69 Fed. Reg. 48008, 48016 n.85 (adopting Regulation SHO); *Division of Market Regulation: Key Points About Regulation SHO,* Section II (Apr. 11, 2005) (providing the example that human or mechanical errors or processing delays can result from transferring securities in physical certificate rather than book-entry form, thus causing a failure to deliver on a long sale within the normal three-day settlement period).

[9] Cf. Release at n.30 and accompanying text.

litigation as many plaintiffs see broker-dealers as deep pocket defendants. The consequence is that short sellers and broker-dealers would be subject to greater legal liability, which in turn would deter legitimate short selling.

The concern of broker-dealers will be heightened by the statement in the Release that "as with any rule, broker-dealers could be liable for aiding and abetting a customer's fraud under the proposed rule." It is well settled that private plaintiffs may not bring charges based on aiding and abetting liability under Section 10(b) or the rules thereunder,[10] so this statement may be confusing in the context of the Commission staff's statement that a private right of action would be available for violations of Rule 10b-21.[11] Even if this statement is clarified to limit it to Commission actions for aiding and abetting, the Release provides no guidance as to what kinds of activity would be viewed by the Commission as aiding and abetting a customer's fraud. This uncertainty may cause broker-dealers to reduce their securities lending activity in connection with short sales or require unnecessary documentation from customers about their locates and long positions, all to the detriment of market efficiency.

We believe the Commission's enforcement authority is sufficient to address any wrongdoing covered by the Proposed Rule, and that the costs of a private right of action would outweigh the benefits of such a right. We accordingly recommend the Commission adopt a narrowly tailored antifraud rule without a private right of action.

C. Customer Locate Representations

As noted in the Release's fourth Request for Comment, the adopting release for Regulation SHO specifically allows a broker-dealer to satisfy the locate requirement by obtaining an appropriate assurance from its customer, provided that the broker-dealer has a reasonable basis for believing the customer's assurance. The Release nevertheless asks whether the Commission should no longer permit a broker-dealer to rely on a customer's assurances.

The ability for a broker-dealer to rely on customer representations about locates is critical to the markets and should not be eliminated or undermined. Virtually all sophisticated investment management firms obtain custody and clearing services separately from trade execution services by entering into prime brokerage arrangements. These arrangements allow the investment manager to obtain best execution for its clients by using many different executing brokers and electronic trading systems, while settling and clearing transactions into a relatively small number of prime brokerage accounts. Securities lending is one of the primary services offered by the prime brokers. So, in a typical short sale, the investment manager first obtains a locate from one of its prime brokers and then executes the short sale with one of many, competing executing brokers. In this situation, the executing broker must rely on the investment manager's assurance regarding the locate, because systems do not currently exist through which the prime broker can automatically or quickly confirm the locate directly to the executing broker. If the SEC were to prohibit the executing broker from relying on the investment manager's assurance regarding the locate, it would effectively require the investment manager to execute the trade only with the

[10] *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994).

[11] This statement in the Release suggests to us that the Commission did not intend that a private right of action would be available.

prime broker that provided the locate, thereby eliminating the valuable competition among executing brokers that promotes best execution.

Further, many sophisticated investment managers have created their own securities lending capabilities, enabling them to borrow securities directly from large custodians. These capabilities can reduce costs for the investment manager's clients and improve access to hard-to-borrow securities, which are often not available from prime brokers. If executing brokers were prohibited from relying on the investment manager's assurances regarding the locate from these sources, transaction costs would increase and investment opportunities for the investment manager's clients would be reduced.

For these reasons, changing the current rules to prohibit a broker-dealer from relying on its customer's assurances to satisfy the locate requirement would increase the costs and reduce the quality of execution for institutional investment managers and their clients and reduce overall liquidity and efficiency in the markets. Therefore, MFA recommends that the Commission continue to permit a broker-dealer to rely on customer assurances in satisfying Regulation SHO's locate requirement.

D. Scope

The Proposed Rule's target is deception in connection with a sale of securities that results in a failure to deliver on settlement date. We believe that the rule can and should be narrowed to reflect the Commission's concerns and achieve the Commission's goals. The text of the Proposed Rule applies its prohibition to all sales of securities, whether short, naked short, or long. However, the release focuses on two instances of deception by sellers: fraudulent misrepresentation about a locate and fraudulent misrepresentation about a "long" position. A locate must be done before a short sale, and a fraudulent misrepresentation about a long position (to avoid the need for a locate) means that the sale is actually a short sale. Accordingly, if the rule were limited to fraudulent misrepresentations about short sales, both of these contexts would be covered.

Moreover, although the Proposed Rule is crafted largely as an adjunct to Regulation SHO and its locate requirement, the rule as proposed would apply more widely. The locate requirement of Regulation SHO applies only to sales of equity securities, but the rule as proposed applies to sales of all securities. This may in fact be a drafting matter, because the Release states that "Proposed Rule 10b-21 would apply to sales in all equity securities."[12]

As there is no record to support the application of this rule to other types of securities, MFA recommends that the Commission clarify that the rule applies only to short sales of equity securities.

E. Direct Market Access Systems

The Release requests comment on the application of the Proposed Rule to the use of direct market access systems ("DMAs") and electronic communications networks ("ECNs"). We do not believe that the Proposed Rule would create any problems in connection with DMAs or ECNs. In

[12] 73 Fed. Reg. at 15380.

this regard, however, it is important that the SEC not impose, without providing an opportunity for public comment, any specific requirements regarding the form or substance of any data that must be communicated through the DMA or ECN at the time of the trade to evidence the customer's locate. The flexibility allowed to broker-dealers in satisfying their documentation obligation in Rule 203(b)(1)(iii) of Regulation SHO should be preserved.

III. Conclusion

MFA appreciates the opportunity to share its views on the Proposed Rule. We would be pleased to meet with the Commission and its staff to further discuss our comments. Please do not hesitate to contact me at 202-367-1140, if we can be of further assistance.

Sincerely,

Richard H. Baker
President and Chief Executive Officer

CC: The Hon. Christopher Cox, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Kathleen L. Casey, Commissioner
Dr. Erik Sirri, Director
Division of Trading and Markets
Mr. James Brigagliano, Associate Director
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