

An Introduction to Short Selling

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I. Foreword

by Richard H. Baker, President and CEO, Managed Funds Association



U.S. capital markets are the deepest, most liquid, and most efficient in the world. They have propelled the United States to be the world's leading financial center and helped sustain our economic growth, even in the face of strong headwinds that have slowed recoveries in other countries.

These benefits are important on a macro-economic, global scale. But there is a more micro – or Main Street – reason why having strong financial markets is important: they help meet the financial needs of local communities. From start-ups to small businesses, homeownership to consumer purchases, strong markets facilitate commerce, job creation, and growth.

Short selling is an integral part of a carefully regulated, well-functioning market. Regulators have recognized the vital role short selling plays and acknowledged that the cost of banning this activity appeared to outweigh the benefits.

Like so many other aspects of our daily lives, markets function best when they represent the broadest possible set of views. Short selling allows investors to say when they believe an asset is overvalued. This contributes to price discovery. The more efficient a market is at determining prices, the better it will function for investors. One way to think about this important process is to compare it to buying a house. You research the neighborhood and check prices of comparable houses before making an offer – and the value you put on the house is sometimes lower than the price on the listing. This is why appraisals are required by your bank: they do not want you to pay more than it is worth.

If investors think markets can only go up, the price of that stock would continue to increase, creating a bubble that eventually has to pop – putting practically every investor at risk. This is what happened following the speculation of the dot-com bubble during the late 1990s. When that bubble burst, stock prices quickly returned to a fair-market value. Investors watched the value of their retirement accounts plummet. When long buyers and short sellers counterbalance each other, prices are more likely to reflect the actual value of the assets. Eliminating short selling skews this balance.

Permitting short selling, particularly with our robust regulatory framework, means that investors can manage risks better and markets can factor in the broadest possible views about a particular stock, bond, or index – reducing the likelihood of future bubbles forming. This helps keep our markets liquid and efficient, which in turn keeps our economy humming.

The following paper provides an introduction to short selling and how it is regulated to help ensure investor protections and prevent abuse. In addition, the paper explores the benefits short selling provides investors as both a risk management tool and a way to meet financial obligations regardless of market conditions.

AN INTRODUCTION TO SHORT SELLING

II. Introduction

Short selling is an important strategy used by investors, including fiduciaries managing others' assets. Market participants engage in short selling for different reasons, including to manage risk, hedge portfolios, and reflect a view that the current market price of a security is above its fair value.

The goal of this paper is to demystify short selling and explain how, through appropriate regulation, it leads to healthier markets for investors and companies.

Key Takeaways

- Investors use short sales for many purposes, including to express a view that a stock is overvalued based on fundamental analysis, to hedge different types of risk in their portfolio and to reduce volatility. Market makers use short sales to facilitate investors' buying and selling stocks.
- Short sales of all types lead to significant benefits for investors, companies, and markets. They can have a stabilizing effect on the market and are not the cause of rapid price declines of stocks. Similarly, short selling does not increase volatility during periods of market stress.
- Short selling activities are federally regulated. The SEC has adopted a comprehensive set of regulations and reporting requirements designed to prevent abusive practices.
- Short sales are distinct from long investments and accordingly are disclosed to the public on an aggregate basis. Disclosure of individual investor short positions would likely lead to negative consequences for investors and companies.



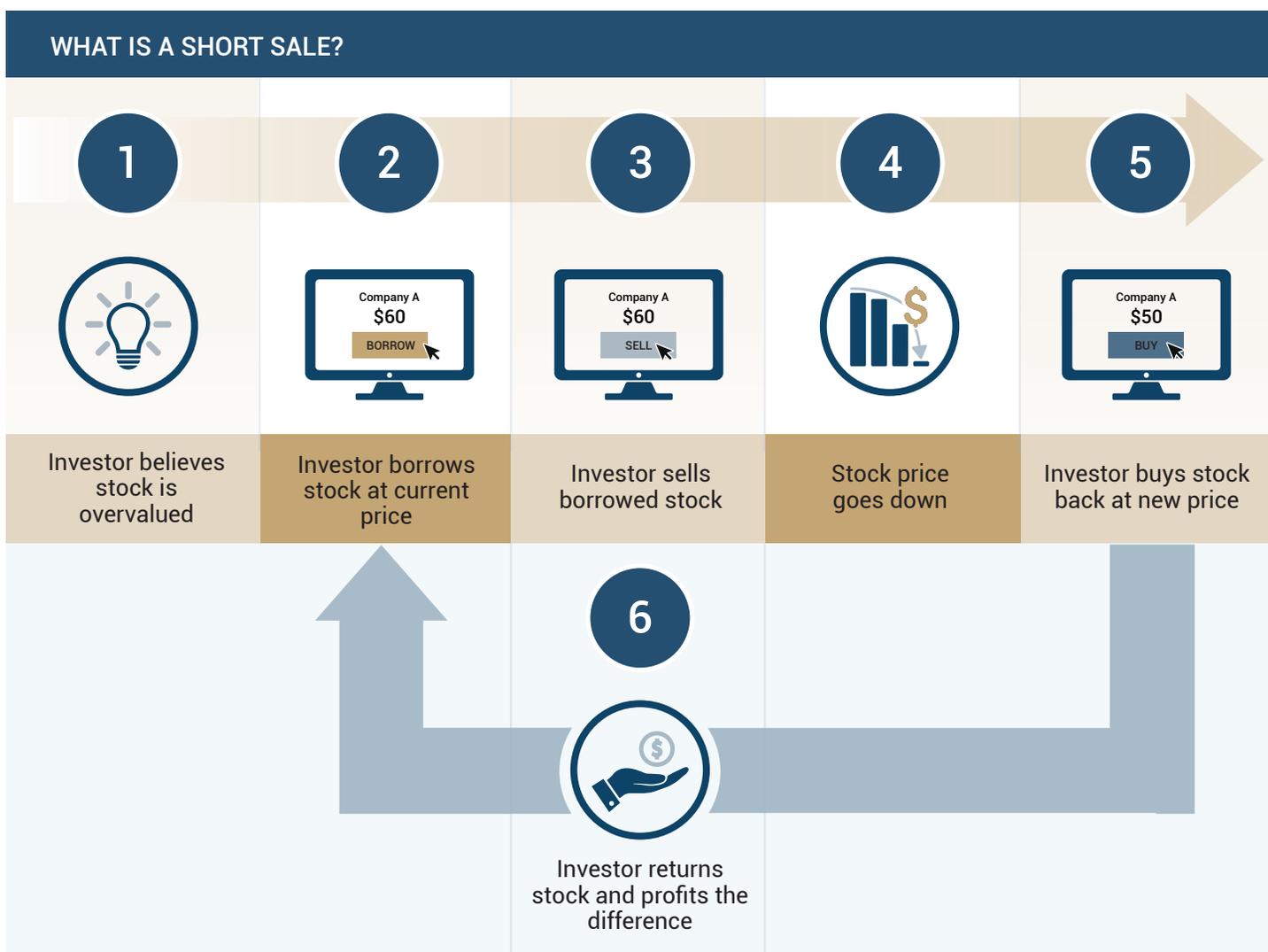
III. What is a Short Sale?

In a short sale, an investor borrows a security and sells it, then later buys back the security and returns it. Typically, the short seller borrows the security from a broker-dealer or an institutional investor, such as a mutual fund, pension fund, or insurance company. The short seller ultimately closes out the short position by purchasing the security on the open market (or by using an equivalent security it already owns), and returns the security to the lender.

For example, an investor may believe that the stock price of Company A is overvalued. Company A is trading at \$60 per share, so the investor borrows shares of Company A stock at \$60 per share and immediately sells them in

a short sale. Later, Company A's stock price declines to \$50 a share, and the investor buys shares back in order to return the borrowed shares. Since the price is lower, the investor profits on the difference – \$10 per share (minus transaction costs and interest paid to the lender). However, if the price of Company A's stock goes up, the investor must buy back shares at a higher price and will lose money.¹

Short sales play an important role in our markets and are quite common. In fact, the SEC has found that short sales account for approximately 49 percent of listed equity share volume.²



1 See Key Points About Regulation SHO, Securities and Exchange Commission, available at: <http://www.sec.gov/investor/pubs/regsho.htm>.

2 See Study on Short Sale Position and Transaction Reporting, SEC Division of Economic and Risk Analysis (June 2014) ("SEC Staff Study"), available at: <https://www.sec.gov/files/short-sale-position-and-transaction-reporting%2C0.pdf>.

Why Are Short Sales Used?

Short sales are used to:

- **Express a view about the value of a company.** Investors engaging in fundamental research typically analyze and interpret public information to determine if they believe a stock is under or overvalued. If they believe a stock is undervalued, investors purchase the stock, while if they believe it is overvalued, they sell the stock. If investors do not own the stock they determine is overvalued, they can sell it by means of a short sale.
 - **Balance investments.** An investor with a short position in a company may later take a long position in the company. An investor engaged in fundamental and extensive research is often able to determine when he/she believes a company has become undervalued and change from a short position to a long position.
 - **Hedge different types of market exposures.** For example, an investor with a long position in the stock of Beverage Company A may also take a short position in the stock of Beverage Company B. The short position is designed to eliminate the risk in the long position of Beverage Company A that the beverage industry underperforms the market. It is not an indication that the investor believes Beverage Company B is overvalued.
 - **Manage portfolio risk.** In the alternative, an investor could take a short position in the stock of Consumer Goods Company A (or multiple consumer goods companies) to reduce the risk in the long position of Beverage Company A that the consumer goods sector underperforms. Again, the short position does not indicate that the investor believes the companies are overvalued; rather the short position is an insurance policy against market downturn in that sector.
- **Reduce the total exposure of a long portfolio to the broader market.** By taking short positions in a basket of stocks, an index, or an ETF, short sales allow investors to minimize the general risk that markets will go up or down.
 - **Reduce risk in positions in the same company.** In a convertible bond arbitrage strategy, an investor purchases convertible bonds of a company and also sells short the company's stock. A convertible bond can be converted into stock at a pre-determined time and price. In this strategy, the investor uses short sales to reduce some of the risk of holding the convertible bonds.
 - **Facilitate market making.** In addition to investors, market makers also use short selling. Market makers are broker-dealers that stand ready to buy and sell stocks on a regular basis at a quoted price. Market makers sell short when filling customer orders for stocks that they do not already hold in their inventory. Market makers also use short selling to facilitate customer orders in other types of securities, such as equity-based options. Market makers have been found to account for about 35 percent of short sales.³

IV. How Do Investors Borrow Securities for Short Sales?

Securities lending is an important part of the short selling process. If an investor sells short and does not arrange to borrow the security, the buyer of the security would not receive the security. This is called “naked shorting” and results in a “failure to deliver” (i.e., the seller fails to deliver the security to the buyer). As explained in more detail below, SEC rules generally prohibit naked shorting.

Broker-dealers and institutional investors often lend securities in connection with short sale transactions. Typically, an institutional investor will lend securities to a broker-dealer, which will relend the securities to an investor for short selling. An institutional investor can generate significant income by lending its securities.

The short selling customer will secure its obligation to return the borrowed security to its broker-dealer lender by posting the short sale proceeds and an additional amount (called margin) with the broker-dealer. The broker-dealer borrower, in turn, secures its obligation to return the borrowed security to the institutional lender by pledging cash or non-cash collateral. Institutional lenders receiving cash collateral typically reinvest it to

generate interest income.

Market conditions determine what the borrower will pay. If the security is generally available to be borrowed in the securities lending market, the institutional lender will rebate to the broker-dealer borrower a small amount based on an interest rate. If the security has limited availability to be borrowed, the broker-dealer borrower may have to pay the institutional lender a small amount (called a negative rebate). In either case, if the collateral is non-cash, the borrower will also pay the lender a loan fee.⁴ When the short seller closes out the short sale, he/she purchases the security and delivers it to the lender.

The securities lending process is an effective method for investors to engage in short selling and for institutional investors to act as lenders and generate additional income for their investors. The broad range of institutional investors lending their shares for short selling is also a clear indication that these investors do not view short selling as detrimental to the price of the shares.



4 See SEC Staff Study at page 5-6.

V. How Does Short Selling Affect Investors, Companies, & Markets?

Investors use short selling as a tool to manage risk and reduce the overall economic exposure of an investment portfolio. Many institutional investors – such as pension funds, endowments, and foundations – invest in investment vehicles that engage in short selling as a means to mitigate overall risk to their portfolios. By using short selling in a manner that hedges risk, investors are able to reduce their overall market exposure and achieve higher risk-adjusted returns.

How Short Selling Helps Investors & Promotes Healthier Markets:

- Increases Price Efficiency
- Provides Market Liquidity
- Promotes Capital Formation
- Reduces Price Bubbles

Short selling helps markets function efficiently by increasing price efficiency,⁵ providing market liquidity,⁶ promoting capital formation, and potentially reducing economy-damaging price bubbles. The SEC and the academic community regularly affirm these important benefits to investors, companies, and markets.⁷ Below is a short description of how these benefits help investors and lead to healthier markets.

Stock Prices are More Accurate

Price efficiency is a measure of how accurately market prices reflect available information. A security's price is deemed to be efficient if it accurately reflects market participants' collective opinion of its fundamental value. An efficient price would reflect both optimistic and pessimistic investor opinions.

Transaction prices best reflect information when investors who make investment decisions on the basis of estimates of fundamental value can invest without restrictions or costs. If fundamental investors do not own the stock they determine is overvalued, they can sell it by means of a short sale. In this way, fundamental investors, such as hedge funds, some mutual funds, and others, contribute to price efficiency through the use of short selling.⁸

Markets are More Liquid & Less Volatile for Investors

Market liquidity is the ability of trades to occur in reasonably large amounts at or near the market price. A liquid security is one in which buyers and sellers can transact in reasonably large sizes with only a minimal impact on the price of the security.

Short selling promotes market liquidity through different methods. One method is through market makers who fill customer orders for securities. Short selling by market makers helps offset imbalances in the flow of buy and sell orders, when demand would otherwise exceed supply.

It is a widely held misconception that short selling increases market volatility during times of extreme market stress, leading to accelerated declines in prices. In fact, evidence shows that during a price decline, short sellers will often sell less, or close out their short positions by purchasing shares of the security, which offsets sales by long position holders.

Perhaps even more importantly, short selling supplies liquidity and reduces volatility when short sellers trade in the opposite direction of price movements. It is a widely held misconception that short selling increases

5 See, e.g., Ekkehart Boehmer & Julie Wu, Short Selling and the Informational Efficiency of Prices, (Working Paper, Aug. 16, 2010), available at: <http://ssrn.com/abstract=972620>.

6 See SEC Staff Study at Appendix E ("The academic literature provides ample theoretical support for, and empirical evidence of, the importance of short selling for liquidity.").

7 Id. ("Theoretical studies support the notion that short sellers promote price efficiency, finding that restrictions on short selling should lead to less accurate prices, higher volatility, and should hinder price discovery.").

8 See SEC Staff Study at page 11.



market volatility during times of extreme market stress, leading to accelerated declines in prices. In fact, evidence shows that during a price decline, short sellers will often sell less, or close out their short positions by purchasing shares of the security, which offsets sales by long position holders.⁹

During the financial crisis, for example, there were claims that short selling was responsible for significant declines in shares of financial companies. In response, the SEC in September 2008 adopted a temporary ban on short sales of financial companies. The “protected” class also included many companies beyond financials. During the temporary ban, however, the shares of these companies continued to decline and did not appear to be affected by the ban.¹⁰

Following the ban, SEC staff analyzed data on short selling activity during the volatile period in early September 2008 that prompted the SEC to adopt the ban. SEC staff found that the results were not consistent with the claim that episodes of extreme negative returns were caused by short selling activity. In fact, the analysis concluded that short sale volume is higher for periods of positive returns than for periods of negative returns.¹¹

After the ban, then-SEC Chairman Christopher Cox indicated that the costs of the ban appeared to outweigh the benefits, and that he would have been unlikely to adopt the ban based on this information.¹²

Then-SEC Chairman Christopher Cox indicated that the costs [associated with a short selling ban] appeared to outweigh the benefits.

Capital is More Efficiently Allocated to Companies

In promoting price efficiency, short selling also improves

9 See, e.g., Daniel Aromi and Cecilia Caglio, Memorandum from SEC Office of Economic Analysis to SEC Chairman Christopher Cox on Short Selling Activity During the First Weeks of September 2008 (Dec. 16, 2008), (“SEC Memorandum”) available at: <http://www.sec.gov/comments/s7-08-09/s70809-369.pdf>.

10 See, e.g., Robert Battalio, Hamid Mehran, and Paul Schultz, Market Declines: What Is Accomplished by Banning Short-Selling?, Federal Reserve Bank of New York, Current Issues in Economics and Finance, vol. 18, no. 5 (2012) (“The preponderance of evidence suggests that the bans did little to slow the decline in the prices of financial stocks.”) (“Federal Reserve Short Selling Paper”), available at: https://www.newyorkfed.org/medialibrary/media/research/current_issues/ci18-5.pdf.

11 See SEC Memorandum (“We find that for all but one subgroup, short selling is higher during periods of extremely positive returns than in periods of extreme negative returns . . . These findings indicate that, on average, short seller’s intraday activity is contrarian. On average, short sales seem to decrease intraday volatility by selling relatively more during periods of positive returns.”).

12 Rachelle Younglai, Reuters, SEC Chief Has Regrets Over Short-selling Ban (Dec. 31, 2008).

13 See Federal Reserve Short Selling Paper at page 2.

the allocation of capital to its most productive uses, which facilitates capital formation.

When a stock is overvalued, the expected return implied by its price is too low, which leads to an artificially low cost of capital. For example, if some stocks are overvalued, too much capital is likely to be allocated to these companies. The result is that overvalued companies may fund less profitable or unprofitable projects, while profitable projects could go unfunded by companies whose stock is undervalued.

Short selling also facilitates capital formation by contributing to more liquid markets. Liquid markets promote capital formation because investors prefer to invest capital in markets with low transaction costs and in which they can quickly establish and liquidate positions.

Reduces the Risk of Market Bubbles

From a long-term perspective, stocks that are overvalued present a problem for the economy. The market will eventually correct the mispricing, but in the meantime, real resources may flow to the overvalued stock or industry. Perhaps the best example was the housing bubble that popped in 2008. Investments in mispriced real estate led to long-term disruptions in the real economy long after the bubble was corrected. Another example was the dot-com bubble, where markets corrected overvalued stocks in a relatively short period of time but firms and employees took much longer to recover.¹³

The absence of short selling in those cases could have made the situation worse. Short selling also helps reduce the risk of future market bubbles.

VI. How are Short Sales Regulated?

The SEC regulates short sales primarily through Regulation SHO, which became effective in 2005. Regulation SHO modernized short selling regulation by addressing concerns regarding persistent failures to deliver and potentially abusive naked short selling.

As noted above, in a naked short sale, the seller does not borrow or arrange to borrow the securities in time to make delivery to the buyer within the standard three-day settlement period. As a result, the seller fails to deliver securities to the buyer when delivery is due (a failure to deliver).

Failures to deliver can also occur for legitimate reasons. For example, human or mechanical errors or processing delays from transferring securities in physical certificate rather than book-entry form could cause a failure to deliver on a long sale. For short sales, market makers that sell short a thinly traded, illiquid stock in response to customer demand may have difficulty obtaining securities in time for delivery.

The SEC designed Regulation SHO to address concerns associated with failures to deliver and it has further amended Regulation SHO to strengthen its requirements and eliminate certain exceptions.

As amended, Regulation SHO imposes the following requirements on short selling:

- **Rule 200 – Marking Requirements:** Rule 200 requires that orders placed with a broker-dealer must be marked “long,” “short,” or “short exempt.”
- **Rule 201 – Short Sale Price Test Circuit Breaker:** Rule 201 is designed to prevent short selling from driving down further the price of a security that has already experienced a significant price decline and to facilitate the ability of long sellers to sell first upon such a decline. The rule restricts the price at which short sales may be effected when a stock has triggered a circuit breaker by experiencing a price decline of at least 10 percent in one day. When the

circuit breaker is in effect, a person may not execute a short sale at a price that is less than or equal to the current price. Once the circuit breaker has been triggered, the price test restriction will apply to short sale orders in that security for the remainder of the day and the following day.

- **Rule 203(b)(1) and (2) – Locate Requirement:** Rule 203 requires a broker-dealer to have reasonable grounds to believe that a security can be borrowed so that it can be delivered on the delivery date before effecting a short sale order in any equity security (known as a locate). This locate must be made and documented prior to effecting the short sale.
- **Rule 204 – Close-out Requirement:** Rule 204 requires broker-dealers to close out failure to deliver positions by purchasing or borrowing securities of like kind and quantity. The broker-dealer generally must close out a failure to deliver for a short sale transaction by no later than the beginning of regular trading hours on the settlement day following the settlement date.

In October 2008, the SEC supplemented the Regulation SHO framework to prevent failures to deliver by adopting Rule 10b-21, an antifraud rule under the Securities Exchange Act of 1934 (Exchange Act). This rule prohibits a customer from deceiving a broker about its intention or ability to deliver a security before the settlement date. Rule 10b-21 reinforces Regulation SHO by imposing additional liability on a person that fails to deliver a security on or before the delivery date.

The Regulation SHO framework for short selling has worked exceedingly well in reducing failures to deliver. In 2011, for example, the SEC’s Division of Risk, Strategy and Financial Innovation, found that since 2008, failures to deliver had declined by 65.7 percent across all securities, and failures to deliver had declined by 85.1 percent for threshold stocks (shares with persistent failures to deliver).¹⁴

¹⁴ See Memorandum from SEC Division of Risk, Strategy and Financial Innovation, Impact of Recent SHO Rule Changes on Fails to Deliver (Apr. 25, 2011), available at: <http://www.sec.gov/spotlight/shortsales/failsmemo042511.pdf>.



Overall, Regulation SHO has been effective in preventing potentially abusive short sale activity. In fact, the SEC has noted that short selling abuse is less common than other types of market abuse.¹⁵

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In addition to Regulation SHO, those engaged in short selling are subject to the broad anti-fraud provisions of the federal securities law, such as Rule 10b-5 under the Exchange Act, which prohibits any manipulative conduct, including intentional dissemination of false information. The SEC has extensive authority to investigate and punish fraudulent conduct.

How Are Short Sales Reported?

In addition to Regulation SHO, the SEC oversees short sales through an extensive system of reporting. There is a substantial amount of information about short sales that is publicly available, and more information is readily available to regulators

Taken together, this information gives regulators quick, easy access to aggregate, market-wide short sale information.

The Financial Industry Regulatory Authority (FINRA), which is the self-regulatory organization (SRO) that regulates and oversees broker-dealers pursuant to SEC oversight, plays an important role in short sale reporting. As the SRO for broker-dealers, FINRA collects short interest information in individual securities from broker-dealers and aggregates the information. FINRA requires that broker-dealers report short positions in all equity securities twice monthly through its online filing.

Information Reported on Short Selling Activity:

- Twice-monthly publicly available short interest information for individual stocks.
- Publicly available daily aggregate short sale volume for individual stocks.
- Institutional investor short sale trading information maintained by broker-dealers and available to the SEC upon request.
- Short selling and other trading data upon implementation of the SEC Consolidated Audit Trail that will be accessible by the SEC and other regulators.

In a process that takes approximately 11 days after the settlement date, or two weeks after the last trading date for the short positions, FINRA validates and aggregates the information and, along with the NYSE and NASDAQ, publishes it.¹⁶

In addition to the short interest reports, FINRA also publishes two other short selling reports in conjunction with stock exchanges. One report is comprised of the daily aggregated short sale volume in individual securities.

A second report provides individual short sale transactions in all exchange-listed equity securities. These data sets are published by FINRA and/or the stock exchanges on no more than a one-month delay and can be found on their websites.¹⁷

¹⁵ See SEC Staff Study at page 74 ("There were 273 Commission enforcement actions from 2004 through 2010 than involved market manipulation. Of these, only 14% involved short-side manipulation while 86% did not involve short selling.")

¹⁶ This information is available at: <http://www.nyxdata.com/Data-Products/NYSE-Group-Short-Interest> and <https://www.nasdaq.com/quotes/short-interest.aspx>.

¹⁷ Links to the short selling data sets can be found at <http://www.sec.gov/answers/shortsalevolume.htm>.

In 2011, the SEC adopted a rule that requires broker-dealers to maintain additional information about the trading activities of large traders.¹⁸ Under the rule, broker-dealers for large traders are required to maintain records of transactions effected through accounts of such large traders and electronically report these transactions to the SEC upon request through the Electronic Blue Sheets systems that are used for reporting trade information.¹⁹ This reporting system has enhanced the SEC's ability to quickly access trading data from such large traders.

The SEC also has broad authority to request short selling information from its registrants, including mutual fund and hedge fund managers, which must maintain the information pursuant to the Investment Advisers Act.²⁰ The SEC uses its authority to detect and investigate any potentially abusive practices.

In addition to these reports, the SEC in the future will have access to additional short sale information. The SEC has adopted a rule to create a Consolidated Audit Trail that would allow regulators to track all activity throughout the U.S. markets in National Market System (NMS) securities.²¹ The rule requires national securities exchanges to submit a plan to create, implement and maintain the Consolidated Audit Trail. In 2016, the SEC approved the plan and soon the Consolidated Audit Trail will allow the SEC and the exchanges to have access to extensive information on all orders to trade NMS securities. Later this year, securities exchanges must begin submitting data to a central repository.

The audit trail data will include information on short sale order marks, the identity of the customer and an open/close indicator. Significantly, the SEC staff has indicated that, with access to this information, the SEC may be able

to run processes to track short selling and buy-to-cover activity and to identify the activity of large short sellers.²²

These short sale reports provide the SEC with detailed information it can use to better ensure that the benefits of short selling flow to investors, companies, and markets while protecting investors.

The Dodd-Frank Act and Short Sale Reporting

The short sale reports that the SEC has established match up well with the section of the Dodd-Frank Act related to short sale reporting. Section 929X(a) of the Dodd-Frank Act instructs the SEC to provide for the public disclosure of aggregate short sale information.²³ In addition to the text of Section 929X(a), the legislative history of the Section confirms that disclosure should be of aggregate, rather than individual, short positions.²⁴ Aggregate information is consistent with the type of short selling information that is currently reported by FINRA and the stock exchanges.

European Short Sale Reporting

In response to the financial crisis, European policymakers established a framework for investors to report and publicly disclose significant short positions in shares of European companies. Since November 2012, the European Regulation on Short Selling and Certain Aspects of Credit Default Swaps (EU SSR) has been in effect. Under the EU SSR, investors must report short positions of 0.2 percent of share capital and above to regulators and disclose short positions of 0.5 percent and above of share capital to the public.

18 Rule 13h-1 under the Exchange Act. A "large trader" includes a person whose securities transactions equal or exceed 2 million shares or \$20 million during any calendar day, or 20 million shares or \$200 million during any calendar month.

19 "Bluesheeting" refers to the system by which the SEC asks a broker-dealer to identify the investor who made a trade that the broker-dealer executed.

20 Rule 204-2.

21 Rule 613 under the Exchange Act. Additional information on the Consolidated Audit Trail Rule is available at: <https://www.sec.gov/divisions/marketreg/rule613-info.htm> and <https://www.catnmsplan.com/home/about-cat/planning/>.

22 See SEC Staff Study at page 24.

23 Section 929X(a) provides that the SEC shall prescribe rules providing for the public disclosure, on at least a monthly basis, of the name of the issuer and the title, class, CUSIP number, aggregate amount of the number of short sales of each security, and any failures to deliver the security following the end of the reporting period. The SEC has not adopted rules under this provision.

24 Section 929X(a) followed from the combination of the House and Senate bills that formed the basis for the Dodd-Frank Act. A review of these bills makes clear that Congress intended for public, aggregate short position disclosure. See letter from Richard H. Baker, President and CEO, Managed funds Association, to James A. Brigagliano, Deputy Director, Division of Trading & Markets, Securities and Exchange Commission, dated Feb. 7, 2011, available at: http://www.managedfunds.org/wp-content/uploads/2011/06/2.7.11-MFA.Letter.on_Short_Sale_Disclosures.under_Section.929X.of_Dodd_Frank.pdf.



In 2017, ESMA published a report on the EU SSR noting that while public disclosure brings increased transparency, it may also lead to pricing inefficiency and could reinforce herding behavior.²⁵

In 2018, in the first comprehensive study²⁶ using data collected between 2013-2016, ESMA analyzed the impacts of the EU's short sale disclosure requirements on European markets (see adjacent box). ESMA found that disclosure thresholds influence the behavior of investors, who avoid crossing reporting thresholds in order to maintain the secrecy of their positions. This suggests that a disclosure regime suppresses market efficiency and the associated price discovery process. Moreover, ESMA found evidence of herding behavior caused by disclosure, observing that the data "strongly suggest that investors react to public disclosure by increasing the size of their [short] position, thereby reinforcing herd behaviour."

The lasting impact of public short position disclosure is likely to be reduced price efficiency and market liquidity, which would make it more difficult for issuers – whether banks, corporates, or sovereigns – to raise capital.

Results of 2018 ESMA Short Sale Disclosure Analysis:

- In 2018, ESMA analyzed the impact of the EU's short sale disclosure requirements on investor behavior. Using data collected between 2013-2016, ESMA found that the EU's disclosure rules influence market outcomes.
- First, ESMA found that market participants seek to avoid public disclosure by avoiding crossing the 0.5 percent threshold, suggesting that the threshold suppresses market efficiency by discouraging further increases in net short positions.
- Second, ESMA found that the public reporting threshold reinforces herding behavior in markets, with disclosure of a net short position above 0.5 percent by one investor leading to subsequent disclosures by other investors.

²⁵ See ESMA's Technical Advice on the evaluation of certain elements of the Short Selling Regulation (Dec. 21, 2017), available at: https://www.esma.europa.eu/sites/default/files/library/technical_advice_on_the_evaluation_of_certain_aspects_of_the_ssr.pdf.

²⁶ See "The Public Disclosure of Net Short Positions," in ESMA Report on Trends, Risks, and Vulnerabilities (April 13, 2018), available at: https://www.esma.europa.eu/sites/default/files/library/esma50-165-538_report_on_trends_risks_and_vulnerabilities_no.1_2018.pdf#page=60.

VII. Short Sale Reporting Requirements and Long Position Reporting Requirements

Many investors are more familiar with the public reporting requirements for holders of long positions. As a result, the reporting requirements for holders of short positions are sometimes compared with the reporting requirements for holders of long positions.

Before examining the different reporting requirements for short and long positions, as well as the reasons for the SEC's determination, here are the SEC's main rules for public disclosure of long positions:

- Investors that own more than five percent of a company's outstanding securities report their long positions publicly either on SEC Schedule 13D or SEC Schedule 13G.
- Institutional investment managers that exercise investment discretion of \$100 million or more in certain U.S. publicly-traded equity securities report their long positions on SEC Form 13F within 45 days of the end of each calendar quarter.²⁷

The remainder of this section explains the different approaches to reporting of long positions and short positions, and the reasons for the SEC's long-standing determination not to require public disclosure of individual investors' short positions.

Disclosure of Individual Long Positions is Based on Voting Rights in Shares

As a holder of a long position in a company, an investor has the right to vote in shareholder elections that influence the direction of the company. A holder of a short position in that company, however, has no voting rights. This fundamental difference leads to different public reporting requirements.

Appropriate public disclosure of long equity positions by large beneficial owners is justified because investors have a legitimate interest in knowing who controls the

Reasons Why Short Sales are Reported Differently than Long Positions:

- Disclosure of Individual Long Positions is Based on Voting Rights in Shares
- Public Disclosure Could Lead to Herding and Increased Volatility
- Public Disclosure of Individual Short Positions is Likely to be Misinterpreted by Investors
- Public Disclosure Would Reduce Price Efficiency, Market Liquidity and Capital Formation, and Increase Market Volatility
- Public Disclosure May Cause Companies to React Adversely to Investors
- Adverse Publicity from Public Disclosure May Deter Investors from Benefiting from Alternative Investment Classes

voting rights that could influence a company. There is no corresponding need for investors or others to know the identity of holders of short positions,²⁸ because short sellers have no ownership and, therefore, no ability to vote as shareholders to influence the company. Accordingly, public disclosure of large long positions on SEC Schedules 13D and 13G is designed to provide investors and companies with information about owners that may have the potential to influence control of the company.²⁹

Likewise, SEC Form 13F also requires public disclosure

27 A position that is fewer than 10,000 shares of a given issuer and less than \$200,000 of aggregate fair market value does not have to be reported on Form 13F.

28 See SEC Staff Study at page 75 ("The objectives of reporting long positions under Section 13 of the Exchange Act are related more to corporate control and investment manager position disclosure than to abusive trading. Therefore, the Division does not believe that short position reporting should necessarily be symmetric with long position reporting.")

29 See Exchange Act Release No. 37403 (July 5, 1996) ("The beneficial ownership reporting requirements embodied in Sections 13(d) and 13(g) of the Securities Exchange Act of 1934 . . . and the regulations adopted thereunder are intended to provide investors and the subject issuer with information about accumulations of securities that may have the potential to change or influence control of the issuer:").



only of long positions. Form 13F reflects a balance between the interests of knowing the owners of a company with the legitimate interests that institutional investors have in safeguarding information about their investments.

Public Disclosure Could Lead to Herding & Increased Volatility

Additional public disclosure of individual short positions may lead to an increase in shorting of stocks (or long sales) if other market participants take positions that follow investors' publicized short positions. This herding behavior could also lead to increased market volatility if potential buyers were then less likely to purchase shares with large short positions.

There are many real-world examples where the behavior of a high-profile investor is likely to have influenced the actions of other market participants and affected a company's share price. Short position reports could exacerbate this herding behavior to the detriment of companies and investors. As noted on page 12, ESMA recently analyzed the EU's short sale disclosure regime and determined that public reporting reinforces herding behavior in markets.

Public Disclosure of Individual Short Positions is Likely to be Misinterpreted by Investors

Investors often take short positions in shares of a company for portfolio risk management purposes rather than because they have taken a negative fundamental view on the particular company. If other investors believe the short position reflects a negative view on the company, the company and other investors who are holding long positions in the company would be adversely impacted.

For example, an investor that is primarily long shares in a particular industry sector may consider that one company's shares are likely to outperform another and may express that view by taking a long position in the first company and a short position in the second company. The investing public is likely to mistakenly interpret disclosure of the short position as an absolute negative view on the company. Misinterpretation of this information is likely to have a greater impact in those industry sectors which are vulnerable to negative public sentiment.

Public Disclosure Would Reduce Price Efficiency, Market Liquidity, Capital Formation, and Increase Market Volatility

Short investors and long investors face a different set of risks. Long investors cannot lose more than they paid for the security, while short sellers can lose as much as the price of the security can rise. Holders of short positions are therefore exposed to unlimited loss in the event of stock prices increasing before they can exit their position.

Public disclosure of short positions may subject market participants to the risk of a short squeeze. A short squeeze is when the price of a security is pushed upward to force short sellers out of their positions. Short sellers are generally required by brokers to maintain margin above a certain level. As prices rise, short sellers must add cash to their margin accounts or close out their short positions. Investors with short positions that are publicly disclosed would be more vulnerable to a short squeeze because other market participants would know the extent of their short positions.

As a result of these unique risks, public disclosure of individual short positions would reduce short selling to a greater extent than public disclosure of long positions. The harm to price efficiency, market liquidity, capital formation and market volatility would flow through to all market participants, not only to short sellers. Institutional and retail investors alike would experience increased transaction costs (i.e., wider bid-ask spreads) and longer times to fill orders. Public companies would face higher costs of capital as a result of less efficient prices and impaired capital formation. And all investors and companies would be subject to the increased risk of price bubbles and higher market volatility.

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Public Disclosure May Cause Companies to React Adversely to Investors

Public disclosure of individual short positions would harm investors if companies cease or limit communications with those investors and exclude them from information sessions. Some firms have in fact indicated they would limit communications with investors they identify to have short positions in their shares. Such a result would have a negative impact on capital markets by limiting the free flow of information essential for informed investments and effective price discovery.

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More broadly, public disclosure of individual short positions could have a long lasting negative impact on markets by having a chilling effect on information and disclosure provided by companies, as well as harming the relationship between investors and companies.

Adverse Publicity from Public Disclosure May Deter Investors from Benefiting from Alternative Investment Classes

Public disclosure of individual short positions could cause institutional investors – such as pension funds, endowments, and foundations – to modify their investments in investment vehicles that engage in short

selling due to the risk of adverse publicity that could arise from inaccurate perceptions of short selling. In the long-term, such investors may forego diversification and risk management benefits provided by alternative investment vehicles, which could ultimately erode returns to these investors.

Public Disclosure Would Reduce Returns for Investors Seeking to Mitigate the Risk Profile of their Portfolio

Public disclosure of individual short positions could provide other market participants with information that they could use to reverse engineer the trading strategies of the short position holder. By carefully analyzing publicly available short positions and long positions of an investor, a sophisticated competitor could understand the investor's investment strategy and use the information in a manner that could be harmful to the investor. As a result, public disclosure would likely cause harm to the investment strategies of investment vehicles and the returns of their investors.



VIII. Conclusion

The SEC regulates short selling in a comprehensive manner through Regulation SHO, which has been effective in deterring abusive practices. The SEC has also established a reporting and disclosure framework that provides regulators and investors with information about short selling. In light of this regulatory structure, public disclosure of individual positions would not provide a meaningful enhancement to oversight of short selling activities.

The SEC has previously assessed the value of the short selling information it receives and considered whether additional information would be helpful.

In 2014, the SEC's Division of Economic and Risk Analysis published a study of the feasibility, benefits, and costs of requiring reporting of short sale positions in real time, either publicly or to the SEC and FINRA.³⁰ In the study, SEC staff compared the potential benefits of receiving real-time short position information with the short sale information it currently has access to and that would become available following implementation of the Consolidated Audit Trail.

“The benefits from making real-time short position reporting information available to the public and regulators are likely to be modest. In particular, the Division believes that real-time short position reporting and transaction marking would provide regulators with little additional information than would already be available from the Consolidated Audit Trail.” - SEC Staff Study (emphasis added)

In the study, SEC staff declined to indicate that this type of additional short sale information would be useful. SEC staff instead concluded that “the benefits from making real-time short position reporting information available to the public and regulators are likely to be modest. In particular, the Division believes that real-time short position reporting and transaction marking would provide regulators with little additional information than

would already be available from the Consolidated Audit Trail.”³¹

In 2009, the SEC had the opportunity to assess the value of additional short sale information reported by investors. During the financial crisis in 2008, the SEC used its emergency powers to require institutional investment managers to submit to the SEC on a weekly basis non-public reports of their short positions on new Form SH.³² The SEC received the short position reports from investment managers for a ten-month period. In July 2009, the SEC allowed the reporting requirement to expire. At that time, the SEC explained that instead of continuing to require managers to report short sale information, it would instead increase the public availability of short sale information through reporting by SROs.

The experience of Form SH appears to illustrate that individual short sale reporting by investors did not materially enhance the SEC's oversight capabilities.

In closing, it is worth recalling that the issue of short selling is not new. In 1934, the Senate Banking and Currency Committee noted that few subjects have been characterized by greater differences of opinion than that of short selling.³³ Congress, however, at that time chose not to prohibit short selling, but instead to grant the SEC power to regulate short sales to prevent any misconduct.

Congress has subsequently reaffirmed that judgment numerous times, including in the Securities Act Amendments of 1975, which created the framework for today's National Market System.

The Dodd-Frank Act likewise reaffirmed that judgment and did not ban short selling or require the SEC to adopt individualized short sale disclosure along the same lines as long position disclosure.

The SEC has used its authority to effectively regulate short selling, and has monitored and revised its rules over time to keep pace with an evolving market. As a result, regulators and academics have recognized short selling as an integral part of well-functioning, efficient equity markets and as a way to help lower transaction costs and promote the responsible allocation of capital.

³⁰ See SEC Staff Study.

³¹ See SEC Staff Study at page vii.

³² For each security, Form SH identified the issuer and CUSIP number, the start of day short position, the number and value of securities sold short during the day, the end of day short position, the largest intraday short position, and the time of the largest intraday short position. Short positions of less than 0.25% of the class of shares with a fair market value of less than \$1 million were not reported. The reporting requirement was implemented by emergency orders followed by an interim final temporary rule, Rule 10a3-T under the Exchange Act; see Securities Exchange Act Release No. 58591 (Sept. 18, 2008).

³³ See Stock Exchange Practices, Report of Senate Committee on Banking and Currency, S. Rep. No. 1455, 73rd Cong. (1934).





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