September 29, 2021

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

RE: Regulatory Notice 21-19 – FINRA Requests Comment on Short Interest Position Reporting Enhancements and Other Changes Related to Short Sale Reporting

Dear Ms. Mitchell:

The Milken Institute Center for Financial Markets appreciates the opportunity to provide comments to FINRA's request for comment on short interest position reporting enhancements and other changes related to short sale reporting.

The Milken Institute is a nonprofit, nonpartisan think tank that promotes evidence-based research that serves as a platform for policymakers, industry practitioners, and community members to come together in catalyzing practical solutions to challenges we face both here in the U.S. and globally. The Center for Financial Markets conducts research and constructs programs designed to facilitate the smooth and efficient operation of financial markets—to help ensure that they are fair and available to those who need them when they need them.

The author of this comment letter served as a Commissioner (August 2013 to July 2018) and Acting Chairman (January 2017 to May 2017) of the U.S. Securities and Exchange Commission ("SEC" or "Commission"). He recently testified in front of the U.S. Senate Committee on Banking, Housing, and Urban Affairs and the U.S. House Committee on Financial Services on the lessons learned from the January 2021 trading frenzy in so-called meme stocks.[1] In his congressional testimonies, he recommended several changes that the

[1] See Written Testimony of Michael S. Piwowar, Executive Director of the Milken Institute Center for Financial Markets, Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, "Who Wins on Wall Street? GameStop, Robinhood, and the State of Retail Investing," March 9, 2021, available at

SEC could make to improve the retail investing landscape. We believe these recommendations for improving transparency in the securities lending market are particularly relevant to the subject of FINRA's request for comment.

Short-Selling and Securities Lending

Some have attributed at least part of the large influx of buy orders that pushed up the stock price of GameStop in January 2021 to a short squeeze, causing short-sellers to buy additional shares at higher prices to cover their short positions. The episode has created a lot of interest in the effects that short-sellers have on the market.

It is important to remember that abusive short-selling – sales to manipulate a stock price – is already illegal. The SEC has promulgated rules to prohibit abusive short-selling practices and regularly enforces those rules.[2] As a result, the vast majority of short sales that occur in the United States are legal.[3]

Academic research shows that short-selling generally has a positive effect on market quality. According to a recent study, "most empirical papers report that during periods of regular trading activity, short-selling has a positive influence on liquidity, price discovery and price efficiency, thus supporting the idea that short-selling is crucial to maintain the orderly functioning of markets."[4,5] The study also determined that, "the existing evidence short-selling cannot be blamed for having triggered downward price reversal during the 2008 financial crisis."[6] Short-sellers also protect other investors by detecting and publicizing fraud.[7]

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https://www.banking.senate.gov/download/piwowar-testimony-3-9-21, and Written Testimony of Michael S. Piwowar, Executive Director of the Milken Institute Center for Financial Markets, Before the U.S. House Committee on Financial Services, "Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide, Part II," March 17, 2021, available at https://democrats-financialservices.house.gov/UploadedFiles/HHRG-117-BA00-Wstate-PiwowarM-20210317.pdf.

[2] See Short Sales (Regulation SHO), Final Rule, SEC Release No. 34-50103 (Jul 28, 2004), 69 Fed. Reg. 48008 (Aug. 6, 2004), available at https://www.sec.gov/rules/final/34-50103.htm.

[3] See, e.g., Key Points About Regulation SHO, SEC Office of Investor Education and Advocacy publication (Apr. 8, 2015), available at https://www.sec.gov/investor/pubs/regsho.htm.

[4] Stefano Alderighi and Pedro Gurrola Perez, What Does Academic Research Say about Short-Selling Bans?, WFE Research Working Paper (Apr. 29, 2020), available at https://ssrn.com/abstract=3775704.

[5] The same study shows that academic research finds that short-selling bans disrupt the orderly functioning of markets. Their negative effects include reducing liquidity, increasing price inefficiency, and hampering price discovery.

[6] Id.

[7] See, e.g., Testimony of Owen A. Lamont, "Hedge Funds and Independent Analysts: How Independent Are Their Relationships?," Hearing before the U.S. Senate Committee on the Judiciary (Jun. 28, 2006), available at https://www.govinfo.gov/content/pkg/CHRG-109shrg31059/html/CHRG-109shrg31059.htm.

Regulation SHO has a "locate" requirement. It requires a broker-dealer to have reasonable grounds to believe, before effecting a short sale order in any equity security, that the security can be borrowed so that it can be delivered on the date delivery is due.[8] However, it has been widely reported that approximately 140 percent of GameStop's stock had been sold short. At least part of this disparity can be attributed to a lack of transparency in securities lending.

Recall the massive U.S. government bailout of the creditors of the insurance giant American International Group, Inc. ("AIG"). AIG's failure was mainly due to its credit default swaps portfolio and its securities lending program, not its insurance business. AIG's credit default swap and securities lending counterparties received much of the government bailout.[9] Title VII of the Dodd-Frank Act[10] established a regulatory framework for swaps (and securities-based swaps), and the SEC and CFTC have promulgated regulations under the statute. Section 984 of Dodd-Frank required the SEC to "promulgate rules that are designed to increase the transparency of information available to brokers, dealers, and investors, with respect to the loan or borrowing of securities."[11]

To date, the SEC has finalized only one rule that could be characterized as being responsive to Dodd-Frank Section 984. To increase the comparability of securities lending fees between open-end funds, the Commission adopted amendments to fund registration statements. The amendments required disclosures relating to fund securities lending activities, including income and fees from securities lending and the fees paid to securities lending agents in the prior fiscal year.[12] These amendments were a good start, but the SEC and FINRA should further improve the transparency of securities lending.

Recommendations for Short-Selling and Securities Lending

We commend FINRA for requesting comment on potential enhancements to its short sale reporting program, and we urge FINRA focus its efforts on creating a reporting framework around stock lending activity. We hope that the SEC will follow FINRA's lead

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[8] See, e.g., Key Points About Regulation SHO, SEC Office of Investor Education and Advocacy publication (Apr. 8, 2015), available at https://www.sec.gov/investor/pubs/regsho.htm.
[9] See, e.g., Congressional Oversight Panel, June Oversight Report, The AIG Rescue and its Impact on Markets, and the Government Exit Strategy (June 10, 2010); Louise Story and Gretchen Morgenson, In U.S. Bailout of AIG, Forgiveness for Big Banks, The New York Times (June 29, 2010); William Greider, The AIG Bailout Scandal, The Nation (Aug. 6, 2010); Scott E. Harrington, The Financial Crisis, Systemic Risk, and the Future of Insurance Regulation (Sept. 2009).
[10] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010).
[11] Dodd-Frank Wall Street Reform and Consumer Protection Act, § 984(b), Pub. L. No. 111-203 (2010).
[12] See, SEC Adopts Rules to Modernize Information Reported by Funds, Require Liquidity Risk Management Programs, and Permit Swing Pricing, Press Release (Oct. 13, 2016), available at https://www.sec.gov/news/pressrelease/2016-215.html.

and hold a public forum and open its own request for comment on the transparency of securities lending. In evaluating various reporting alternatives, FINRA and the SEC should distinguish between “regulatory reporting” and “public transparency.” Regulatory reporting refers to the information available to FINRA and the SEC to perform their regulatory functions. Public transparency refers to the information that FINRA and the SEC make available to market participants, investors, and academic researchers.

Then, FINRA and the SEC should use economic analyses to determine whether and, if so, how to increase regulatory reporting in securities lending. FINRA and the SEC should conduct separate economic analyses to determine how much, if any, new information should be provided to the public.

Conclusion

The Milken Institute appreciates the opportunity to respond to FINRA’s request for comments on potential enhancements to its short sale reporting program. We commend FINRA for its leadership on improving the usefulness of important information to FINRA, other regulators, investors, and other market participants. We welcome the opportunity to discuss our thoughts and recommendations in greater detail.

Sincerely,

Michael S. Piwowar
Executive Director, Milken Institute Center for Financial Markets

Cc: Robert W. Cook, President and Chief Executive Officer
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