August 14, 2021

Jennifer Piorko Mitchell, Office of the Corporate Secretary

FINRA

1735 K Street, NW

Washington, D.C. 20006-1506

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Re: FINRA Regulatory Notice 21-19; Short Sales, FINRA Requests Comment on Short Interest Position Reporting Enhancements and Other Changes Related to Short Sale Reporting

Dear Ms. Mitchell:

I appreciate the opportunity to provide feedback and comment regarding the FINRA's request for comments on short interest position reporting enhancements and other aspects related to short-sale reporting. This may result in significant changes in short-sale regulation.

By way of background, the author of this comment letter has studied a broad range of issues involving trading and market structure of securities markets, especially equity markets. He has served as Chief Economist of the Securities and Exchange Commission (2004-2007) during the adoption and implementation of Regulation NMS (National Market System) and implementation of Regulation SHO and the SEC's pilot analysis to remove restrictions banning short sales on down ticks. He served as a member of the SEC's Equity Market Structure Advisory Committee (EMSAC) from 2015 through 2017.[1]

Short selling is a fundamental aspect of trading in the equity markets at many levels. A significant portion of intermediation and liquidity provision occurs by traders and market makers who are net short at a point in time, limiting somewhat the cost of liquidity provision. Some longer horizon investors also have a short interest exposure in particular stocks, providing these investors an opportunity to express negative overall views about a stock. In these manners short selling reduces the cost of liquidity provision and helps protect investors against purchasing overpriced assets. The latter is a fundamental aspect of investor protection that is at the foundation of our capital markets. Excess regulation of short sales would discourage such activity and thereby weaken

[1] Spatt was one of the founders in the mid-1980s of the *Review of Financial Studies* (which quickly emerged as among the three leading journals in finance) and its second executive editor and served as President of both the Society for Financial Society and the Western Finance Association. Besides the EMSAC, he also has served as a member of both the Model Validation Council of the Federal Reserve System and the Advisory Committee of the Office of Financial Research as well as various non-governmental groups, such as the Systemic Risk Council, the Shadow Financial Regulatory Committee and the Financial Economists Roundtable. He has provided comment letters on various issues involving market structure and other aspects of financial markets to the SEC, FINRA and the Commodity Futures Trading Commission.

investor protection. This is an important feature to consider when implementing new disclosure requirements on short selling.

While I am not advocating against all potential increases in short-sale regulation and disclosure, I do think that that it is important to set the bar appropriately high in light of the importance of short selling to protect investors against purchasing overpriced assets. Events surrounding GameStop and other meme stocks also raise interesting questions about the possibility of coordinated "pump and dump" efforts to squeeze potential short sellers, particularly if these would rise to the level of market manipulation. One concern about enhanced public disclosures of short selling would be to avoid facilitating coordinated efforts to squeeze short sellers and discourage short sales. To the extent that the enhanced disclosures were to a regulator to allow it to improve its performance based upon regulatory needs, this concern about enhanced disclosures would not be as significant as if the disclosures were provided to the public (though there still would be some costs associated with the enhanced disclosures). It is important to avoid needlessly encouraging asset managers from no longer allocating capital to short selling.

One important matter that bears emphasis is that the frictional costs of short sale positions are relatively greater than that associated with long positions. This reflects the nature of the unlimited liability associated with short positions and the need for supplemental collateral to ensure performance in the event of an increasing price of the shorted asset. The limited access to the short-sale proceeds also reflects the need to ensure performance by the short seller and reinforces the costs experienced by investors who are short. In many cases retail investors do not even benefit from the time value of the short-sale proceeds, perhaps suggesting less competition in brokerage on the short-sale side of the market.

The frictional costs of short-sale exposures are an important issue for regulators and the public to understand. One way to significantly increase understanding of the costs of shorting is for regulators to promote transparency in the cost of lending. Yet there is little available information to facilitate such analyses due to the considerable opacity in the cost of lending. Additionally, enhanced transparency in lending would reduce the frictions associated with lending and lead to more competitive pricing. This would be important to the lending market, just as the enhanced transparency in bond pricing facilitates competition in that context.

A variety of studies have highlighted that price transparency has led to the reduction of the trading costs in fixed-income markets.[2] In the securities lending context greater transparency would allow understanding by long investors of the value of loaning securities—at least in the presence of sufficient competition among brokers competing to offer lending services. This would reduce the frictions and costs associated with securities lending and potentially place short sales on a more level playing field without artificial frictions that needlessly diminish short sales. One aspect of short-sale regulation where I do feel that stronger disclosure regulations would be warranted would be through greater transparency about lending and its pricing.

Sincerely,

Chester Spatt
Pamela R. and Kenneth B. Dunn Professor of Finance, Tepper School, Carnegie Mellon University and former Chief Economist, U.S. Securities and Exchange Commission (2004—2007);

Cc: Robert W. Cook, President and Chief Executive Officer
Robert L.D. Colby, Executive Vice President and Chief Legal Officer
Jonathan Sokobin, Senior Vice President and Chief Economist

[2] See, for example, H. Bessembinder and W. Maxwell, 2008, "Transparency and the Corporate Bond Market," *Journal of Economic Perspectives* 22, 217-234; P. Asquith, T. Covert and P. Pathak, 2013, "The Effects of Mandatory Transparency in Financial Market Design: Evidence from the Corporate Bond Market, NBER Working Paper No. 19417; and F. Trebbi and K. Xiao, 2019, "Regulation and Market Liquidity," *Management Science* 65, 1949-1968.