Title: My comment on the Short Reporting rule 13f-2. No doing the bare minimum, no synthetic shorting in the dark.
Author: disoriented_llama
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Linked Post Content:

Exchange-Traded Funds: Short-Selling, Creation, and Redemption

In Proposed Rule 13f-2, the Commission asked the following questions (pp. 48, 49).

- ETFs would be included under Proposed Rule 13f-2. Should ETFs be excluded from Proposed Rule 13f-2? If yes, describe why. If no, explain why not.
- ETF creations and redemptions would be included under Proposed Rule 13f-2. Should ETF creations and redemptions be excluded from Proposed Rule 13f-2? If yes, describe why. If no, explain why not.

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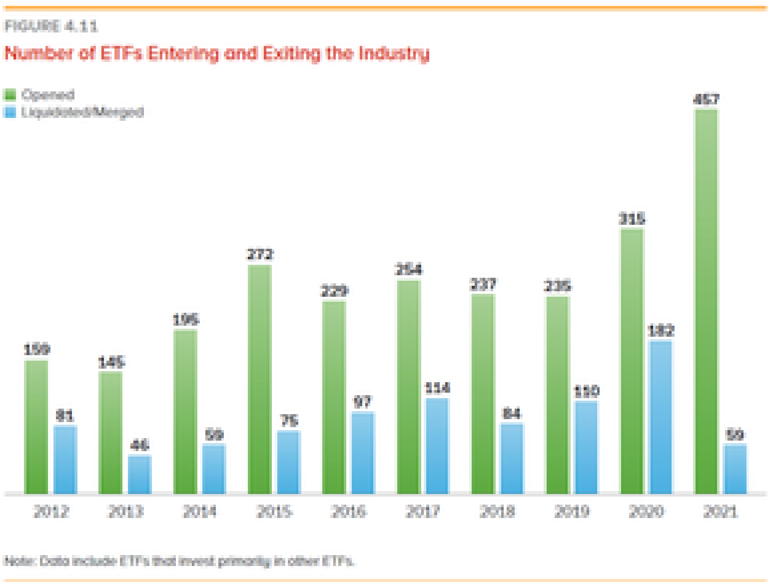
I urge the Commission to include ETFs in Proposed Rule 13f-2, as well as creations and redemptions. The arguments follow.

Shorting Via ETF Produces System-Wide Risks

Critically, the authors warn that operational shorting presents a system-wide risk: "A spike in operational shorting/FTDs, coinciding with a drop in liquidity in the ETF by an AP in one ETF would create a ripple effect to other ETFs within the same AP, and to other APs making markets in a common set of ETFs. This ripple effect, magnified by how close each AP is to their regulatory leverage constraint, could reverberate throughout the entire ETF market and consequently increase counter risk and system wide stress not only with ETFs but also with ETF-related common stocks and derivatives." The authors explicitly note that these effects are magnified by financial leverage, and I note that financial leverage is 'normally' and currently used to extreme excess. The explosion in the number of ETFs in the industry necessitates overlap and likely increase the systemic risk posed by continual and frequent shorting concentrated among a few dominant APs:



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[9] Karmaziene, E., & Sokolovski, V. (2022). *Short-Selling Equity Exchange Traded Funds and Its Effect on Stock Market Liquidity. Journal of Financial and Quantitative Analysis*, *57*(3), 923-956. Available at http://wp.lancs.ac.uk/mhf2019/files/2019/05/MHF-2019-022-Egle-Karmaziene.pdf

[10] https://www.sec.gov/files/Market%20Manipulations%20and%20Case%20Studies.pdf

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[11] Collins, S., Antoniewicz, R.S., Holden, S. & Steenstra, J. (2022). U.S. Exchange-Traded Funds, *2022 Investment Company Fact Book* (66-85). Investment Company Institute. Retrieved from https://www.icifactbook.org/pdf/2022_factbook_ch4.pdf

October 15, 2022

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 205499–1090
rule-comments@sec.gov

Re: Release No. 34–94313; File No. S7–08–22 Short Position and Short Activity Reporting by Institutional Investment Managers

Ms. Countryman:

I am writing out of concern for the lax approach to short-selling activity reporting suggested by the Proposed Rule's current state, and have some suggestions for how the rule might be brought in better alignment with the Commission's repeatedly-stated first priority of investor protection.

Short-Selling has Serious Consequences

The Commission has identified the following shortcomings with current data: "(1) fails to distinguish economic short exposure from hedged positions or intraday trading, (2) fails to distinguish the type of trader short selling or identify individual short positions, even for regulatory use, and (3) fails to capture the various ways that short positions can change and the various ways to acquire short exposure."[1] In addition, The Commission explained that "short selling volume and transactions data cannot easily explain changes in short interest, exposing a gap between these two types of existing data."[2] Furthermore, these data sets are subject to differences in reporting lag, and can misrepresent the amount of short selling due to mismarking.

Provision of data on ETF-level short activity would grant market participants a more complete view of the securities they own, increasing market fairness and allowing investors to better protect themselves against potentially malicious and abusive market forces. Because of how common operational shorting via ETFs is, investors need visibility into this source of short activity to gain an accurate understanding of the state, history, and ongoing performance of any security in which they would like to invest.

Synthetic Shorting Via ETF Allows Funds to Ignore the Commission

In the 2008 Financial Crisis, the Commission temporarily banned short sales on 797 securities, yet the ban list did not include any ETFs. Many market participants elected to legally ignore the Commission's order by short selling ETFs instead.[9]

In fact, ETFs are not and have never been subject to the "uptick rule" designed by the Commission to impede short-selling activities. Synthetic shorting via ETF allows funds and firms to simply walk around short selling rules enacted by the Commission. This is inappropriate. Inclusion of ETFs in the proposed regulations will grant the public greater insight into how shorting via ETF allows funds and firms to decline to be regulated by the Commission's rules.

Importantly, shorting via ETF was found to be more common in more thinly-traded and/or hard-to-borrow securities. This is the exact same set of situations the Commission itself trains its own investigators to focus on as common targets of abusive and manipulative practices[10]: "*Market manipulations typically involve thinly traded shares of little known or start up companies*", and "*With small volume of trading, it is easier to effect the price of the stock.*" The Commission also notes that "*Sophisticated value traders generally cannot sell securities that they cannot borrow. Short selling cannot be covered.*"

Given that ETF short-selling activity is actively used to circumvent regulations and the law, and that it tends to occur within the exact conditions the Commission warns investors *and its own employees* to watch for abuse, the Commission itself should include ETF short activity in reporting requirements to, in fact, watch those conditions for abuse.

These gaps in the ability to detect fraud and abuse are put in sharp relief by the seriousness and apparent frequency of that abuse. Less than a year ago, the Department of Justice embarked on a wide-ranging investigation of short-selling activity. This dedication of resources and time is substantial and represents the magnitude of the threat short-selling po: to the markets and investors. Investor protection comes first and the Commission has a responsibility to do its best to collect data that prevents fraud and manipulation from passing undetected, and that will assist the Department of Justice in its investigations.

Given the threats to investors and to the fairness of the markets themselves, I was shocked to learn that the Commission sees fit to deliver the bare minimum in Proposed Rule 13f-2.

Why Is the Commission Doing the Bare Minimum?

Proposed Rule 13f-2 requires short activity reporting once per month. A reading of Section 929X of the Dodd-Frank Act reveals that "At a minimum, such public disclosure [of short-selling activity] shall occur every month." At a minimum. Why has the Commission elected to do the bare minimum as required by law? This communicates a troubling lack of motivation to examine short-selling at all; one might reasonably think that the Commission would do even less to monitor short-selling activity if the Dodd-Frank Act did not require it. Taking the bare minimum action required by law is not in step with the Commission (repeatedly) stated first priority of investor protection. Reporting must be more frequent to allow better and more efficient detection of manipulation and fraud, helping the Commission make the most of its poor resources (the current Chairman commonly mentioned the Commission's insufficient resources). Failing those resources, greater resolution of publicly-disclosed data empowers individual investors to protect themselves and each other, and to assist the Commission via its whistleblower program.

So: reporting should be more frequent. How frequent? Section 929X clearly and specifically states that short-selling activity should be reported in aggregate, and clearly and specifically empowers the Commission to determine any other information necessary for the protection of investors and the public interest. This suggests a balance must be struck: reporting must be as frequent as possible to protect the public and promote its interests, yet also not so frequent that it strains the concept of "aggregate". Given the Commission's proposal of a 15-minute aggregate reporting period in Proposed Rule 10c-1, that seems to be a reasonable point. This allows investors, the Commission, and the Department of Justice to review short-selling at a strong resolution, while still preventing moment-by-moment, manager-level examination of flash crashes, short attacks, and the like. If 15-minute aggregation is too much for the Commission's current appetite, one day would be sufficient.

Include Exchange-Traded Funds, Creations, and Redemptions in the Proposed Rule

Taken all together, the above suggests to me that the Commission has a responsibility to include ETFs in short-selling activity reporting, including the creation and redemption components of operational shorting. ETF short-selling is clearly used to ignore the Commissions orders and regulations, and it tends to occur in situations the Commission states is ripe for investor abuse and deserving of special focus. Further, operational shorting (creation and redemption) is (a) a fundamental part of the aforementioned short-selling activity, (b) carries significantly profit incentives for APs, (c) tends to occur in the same abusive situations, and (d) represents a source of profound systemic risk which on its own warrants closer observance by the Commission.

Increase the Resolution of Data Available to Investors, the Commission, and the Department of Justice

When it comes to the protection of investors, the Commission should not do the bare minimum required by law, which is directly identified at the bare minimum within the law. I urge the Commission to adopt 15-minute aggregation periods. Failing that, one day should be in line with the Commission's stated priorities and its new strategic direction.

Sincerely,
A Concerned Investor

Synthetic Shorting Via ETF Is a Common Practice

ETF activity is growing steadily and potentially accelerating. Work in 2018 shows ETFs as 10% of U.S. equity market capitalization[3], which grew to 11% in March 2021[1], to over 13.5% to date[2]. Shorting via ETF, as of June 2020, constituted 20% of the overall dollar value of short interest in U.S. equity markets. The popularity of shorting via ETF results in some ETFs being shorted at 200%, 400%, all the way over 1000%[4]. This consistently huge level of short interest may in fact indicate regular and significant abuse of particular thinly-traded securities included in those ETFs.[5]

In an examination of synthetic short-selling activity using ETFs, Li and Zhu[6] find that *"directional betting, especially synthetic shorting, is an important component of ETF shorting activities"*, noting that *"hedge funds frequently create synthetic shorting using ETFs, particularly when it is costly or outright impossible"* to do so, and *"some hedge funds prefer using ETFs to short underlying stocks so that their rivals cannot easily detect their trading strategies."* The authors also found estimates of shorting activity using ETF-based activity "strongly forecasts stock returns, even after controlling for stock-level shorting measures". Even APs have a significant profit incentive to use operational shorting: if the price declines in the time the AP is waiting to deliver, they earn the bid-ask spread without paying trading costs.

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[3] Evans, Richard B. and Moussawi, Rabih and Pagano, Michael S. and Sedunov, John, Operational Shorting and ETF Liquidity Provision (January 2018). Available at https://jacobslevycenter.wharton.upenn.edu/wp-content/uploads/2018/08/ETF-Short-Interest-and-Failures-to-Deliver.pdf

[1] Evans, R. B., Moussawi, R., Pagano, M. S., & Sedunov, J. (2019). ETF short interest and failures-to-deliver: Naked short-selling or operational shorting?. Available at https://www.researchgate.net/profile/Rabih_Moussawi/publication/319910936_ETF_Short_Interest_and_Failures_to_Deliver_Naked_Short_Selling_or_Operational_Shorting/links/[illegible]/ETF-Short-Interest-and-Failures-to-Deliver-Naked-Short-Selling-or-Operational-Shorting.pdf

[2] Evans, R. B., Moussawi, R., Pagano, M. S., & Sedunov, J. (2022). Operational Shorting and ETF Liquidity Provision. *Available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=[illegible]151062

[4] [Online Forum Post] u/PSClay ("XRT Tracker Guy", 2022). *1298.97% Short Interest XRT !!!* Reddit, SuperStonk. Retrieved October 15, 2022, from https://www.reddit.com/r/Superstonk/comments/[illegible]/1298_97_short_interest_xrt/

[5] [Online Forum Post] u/Turdfurg23 ("ETF Tracker Guy", 2022). *The Law of Unintended Consequences.* Reddit, SuperStonk. Retrieved October 15, 2022, from https://www.reddit.com/r/Superstonk/comments/[illegible]/the_law_of_unintended_consequences

[6] Li, F. W., & Zhu, Q. (2018). Short selling etfs. *Finance Down Under 2019 Building on the Best from the Cellars of Finance, Review of Asset Pricing Studies, Forthcoming.*