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Walter Cruttenden
CruttendenPartners
4600 Campus Drive
Newport Beach, Ca. 92660
(949) 399 0300

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OFFICE OF THE SECRETARY

Chairman Mary Schapiro
SEC Headquarters
100 F Street, NE
Washington, DC 20549

Re: Economic Problems Associated with Unregulated Short Sales

Dear Chairman Schapiro

It is my understanding that you are working on solving the unregulated short sales problem. As a 40 year veteran of the securities industry I would like to offer my insight.

The unregulated shorting of widely held equity securities (such as the shares of Bank of America or Citicorp, etc.) has severely exacerbated the economic problems of this nation at a time that the American people can least afford it.

Because the flaws in the mechanics of shorting securities are little understood (even by those within Wall Street and the regulatory agencies) the economic dislocations caused by unregulated shorting have been allowed to perpetuate resulting in billions of dollars of damages to IRAs, 401Ks, pension funds and long-term investors in general.

To illustrate the problems with this regulatory oversight and the economic consequences let me first provide a layman's explanation of two aspects of "unregulated shorting" and then paint a picture of the economic repercussions resulting from such an activity when done en mass, as is the case in the securities markets today.

One aspect of **"Unregulated Shorting"** is the act of shorting (selling without owning) securities without first borrowing and delivering the physical shares. Presently, there are many traders that search out companies that are the subject of bad news hoping to gain by shorting (selling) the shares at a high price and repurchasing the shares later at a lower price. This is a perfectly valid economic action to take if one either **A.** owns the shares and is thus shorting the shares to hedge their portfolio for self protection, or **B.** is a regulated market maker with an obligation to make a "fair and orderly market" (which is now required of all designated market makers), or **C.** someone that has made a bonafide effort to borrow the shares from a holder that does not mind lending them to a trader that wants to bet against that holder.

The problem is "C". Most people and institutions that now short securities never made arrangements to physically borrow the shares, and most long-term holders would never allow their shares to be borrowed if they were aware that the shares were being sold and this action would effectively reduce the price of their holdings. Thus much of the shorting that now occurs (simply through electronic trading and clearing platforms) goes on under false economic pretense and lacks the discipline of the original purpose of shorting securities, which at one time was a very rare event. (Before the days of clearing houses, only traders that could personally talk someone into lending them shares could sell short – and market makers that would do it to smooth out an imbalance of buy orders).

There is another attendant problem, which is the recent ability to short (sell borrowed shares) without an "uptick" in the price of the securities being sold. The uptick rule (meaning the price must momentarily trade upward before a short sale is allowed) was in effect since the inception of the practice and kept short sale traders from creating a self fulfilling prophecy. In other words, it limited their ability to force a stock price down. With growing market complexity, increased trading volume and reduced transaction time over recent years this rule was deemed to be no longer necessary. Thus the uptick rule was dropped right before the market began its severe decline of 2008 and 2009.

"Economic Problems" resulting from widespread shorting and the shorting of shares that were never physically borrowed with the holder's knowledge can be insidious when allowed to persist. They rob the true economic risk takers (the long term shareholders) from the ability to mitigate their losses while exaggerating price declines and adding to a loss of confidence in the markets. This weakens of the economy in several ways. For example, if there is bad news out on Bank of America (such as an announcement of increased reserves for mortgage write-offs), the first people to sell those shares are typically short side traders glued to computers and reacting to the news. The actual shareholders of Bank of America rarely have a chance to digest the news and decide if the want to sell their shares or hold them for the long term as the short side traders have already impacted the stock price. This robs the patient shareholder of a chance to sell at a higher price and tends to perpetuate the decline as the unregulated shorting typically causes a sharp drop in price, which erodes the confidence of shareholders that might otherwise have never sold.

The cycle that results from this action magnifies the damage to all parties except those that have shorted the shares. The severity of the result can be seen in the price movement of shares where the subject company might have announced an operating loss of several billion dollars but actually suffered a loss in market value equal to many times this amount in a single day. (See case studies of major financial companies in 2008 and 2009). When multiplied across a number of companies on a continuous basis it is easy to understand why many long-term investors have opted to flee the equity markets. Needless to say, when the capital markets of a nation operate in such a gun slinging manner this causes a lack of confidence that has wide ranging economic implications for that nation. Pension fund, IRA and 401K values are diminished, capital becomes harder to raise, risk taking is discouraged and therefore job formation is squashed. This leads to higher unemployment (and raises government unemployment costs), reduces economic activity and business operating profits, and sets off an economic ripple effect that can go on for many years. Thus, the mortgage losses of several hundred billion dollars from a limited segment of financial companies can translate into the loss of trillions of dollars of market value for a generation of investors. This means long term damage to the real economy. The domino effect from unregulated short sellers can hardly be under estimated in a leveraged economy dependent on stable market values.

S.E.C. Response

In a recent letter to Chris Cox pointing out the problems of unregulated shorting (including shorting without an uptick and shorting without appropriate physical delivery), the response was defensive and showed a lack of understanding of the technicalities or magnitude of the problem. In summary, the SEC at that time displayed only a vague understanding of the physical delivery problem and defended the recent waiver of the uptick sale rule by saying they had conducted a test and did not find a problem.

In hindsight, it is obvious that a valid test was never carried out under severe market conditions because such conditions never existed during the test period, which was conducted prior to the market volatility of 2008 and 2009.

One must remember that shorting is generally most fruitful for the trader when companies are having economic difficulty. If a test had been carried out in the present economic environment, the SEC would have noticed a large increase in shorting (as evidenced by the increase in the number of funds now established to benefit from short sales and other market declines) and it is highly doubtful that unregulated shorting would have been allowed. The harmful consequences of excessive shorting are not only that more and more people have a vested interest in seeing share prices decline (and are therefore helping to cause such declines), but that such declines become self-fulfilling and perpetuate economic hardship.

Solutions

The quickest and fastest solution would be to immediately ban new shorting of securities by anyone other than a bonafide market maker or holder of those securities until such time as more comprehensive shorting regulations can be introduced. The new regulations should require **A.** a return to the old uptick rule that means no shares can be shorted except on an uptick (this would bring order to the rapid short process and save many stocks from fast exaggerated declines), and **B.** before any shares can be shorted they must first be borrowed from a actual shareholder with that shareholders consent.

I am a 40-year veteran of the securities business and have worked in most capacities of the trading, back office, and capital markets functions, from clerk to CEO, within the brokerage and investment banking industry. Never before have I been so concerned about the unregulated shorting that has damaged the economic vitality of our nation. I urge the SEC, or Congress if necessary, to take immediate and swift action to address this serious problem.

Sincerely

Walter Cruttenden
Retired Investment Banker
Walter@CruttendenPartners.com