charles SCHWAB

JEFFREY T. BROWN Senior Vice President
Office of Legislative and Regulatory Affairs
555 12th Street, NW Suite 740N
Washington, DC 20004
tel 202.662.4902 fax 202.638.3823

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE,
Washington, DC 20549-1090

Re: File No. S7-08-09

Dear Ms. Murphy:

Charles Schwab & Co., Inc., and its affiliates ("Schwab") engage in a range of financial activities, including retail brokerage, mutual funds, banking and services to investment advisers and retirement plans. Throughout these businesses, there has been concern over the impact of unrestricted short selling in our markets. We appreciate, therefore, the opportunity to comment on the Securities and Exchange Commission's ("Commission" or "SEC") recent proposals to restrict short selling by amending Regulation SHO.[1]

Schwab believes that the re-introduction of an uptick rule is necessary for the restoration of retail investor confidence. Retail investors will trade in a market they believe is fair and avoid one they believe is susceptible to manipulation. That is where we are today. In the last eighteen months, Schwab customers have moved out of equities and into other asset classes even if those assets provide minimal return. In the absence of an uptick rule, investors believe that the dramatic bear raids of last year were orchestrated to transfer trillions of dollars of investor assets to manipulative short sellers. It is time to make manipulation more difficult by ending unrestricted short selling through the adoption of an uptick rule.

We use the term "uptick rule," however, as a term of art. To be more precise, we support the adoption of a market-wide, full-time price test that limits short sale executions to prices above the national best bid ("Bid test") in a security. In its release, the Commission proposed two approaches, each with multiple variations, to restricting short sales. The first approach is to impose market-wide, full-time price tests; one is the bid test and the other keyed off of the last sale price in a security ("Uptick test"). The other approach proposed by the Commission is more security focused. Depending on the Commission's choice, it could apply a Bid test, the Uptick test, or a full ban on short selling in a particular security but only once that security has suffered a severe decline in share price. As discussed below, we have concerns with the Uptick rule because of the non-sequential nature of trade reporting. We also have concerns with the circuit

[1] Securities Exchange Act Release No. 59748 (April 13, 2009), 74 FR 18042 (April 20, 2009).

breaker approach because it permits a severe decline to occur before imposing short sale restrictions. If short sale restrictions have merit, and we believe they do, Schwab rejects waiting until a security has been subject to a severe downdraft before imposing their investor protections. Consequently, we urge the Commission to act swiftly to adopt the Bid test on a market-wide, full-time basis.

Why We need a Price Test Restriction

Schwab wholeheartedly supports short selling as an important market tool. Short selling provides liquidity to buyers in rising markets and short sellers are natural buyers of stocks in falling markets. In doing so, short sellers may temper excessive volatility in price movements both on the upside and the downside. The concern we have, however, is that unrestricted short selling may also exacerbate downward price movements when short sellers exhaust bid liquidity, compounding fear over price stability and ultimately causing panic among long investors. Schwab believes that the last eighteen months have witnessed this manipulative phenomenon.

Rules governing short selling originated in the late 1930s following what was perceived to be massive manipulation in markets during the early part of the decade. In 1938, the Commission adopted Rule 10a-1 to restrict short selling in a declining market.[2] Rule 10a-1 provided that a security may be sold short (A) at a price above the price at which the immediately preceding sale was effected (plus tick), or (B) at the last sale price if it is higher than the last different price (zero-plus tick). This became know as the "uptick test." Short sales were not permitted on minus ticks or zero-minus ticks.

The original rule only applied to securities listed on an exchange. Securities listed on the Nasdaq market, which was not an exchange until recently, were not subject to the rule. Recognizing the need for short sale regulation, the National Association of Securities Dealers ("NASD"), the then owner and regulator of the Nasdaq market, adopted its own short sale restriction. The NASD rule, Rule 3350, was based on the last bid in a security reflected on the Nasdaq market. The rule stated: "no member shall effect a short sale . . . in a Nasdaq National Market security at or below the current best (inside) bid displayed in the Nasdaq Market Center when the current best (inside) bid is below the preceding best (inside) bid in the security."[3] This was known as the "bid test."

Both rules were designed to restrict sellers from driving stocks excessively down through the use of short stock and both rules were subject to exceptions where the Commission believed that the potential manipulative effect of short selling was not present. These exceptions grew more numerous over the years as new market structures developed. When combined with decimal pricing, which created many more price points to execute upticks, many argued that the rules no longer were effective and should be abandoned.

The Commission reacted by launching a pilot program to study whether the new market practices required change to the rules governing short sales.[4] Under the Pilot study, the Commission

---

[2] *See* Securities Exchange Act Release No. 1548(Jan. 24, 1938), 3 FR (Jan. 26, 1938).
[3] Former NASD Rule 3350.
[4] Securities Exchange Act Release No. 50104 (July 28, 2004), 69 FR 48032 (Aug. 6, 2004).

eliminated both the uptick rule and the bid test for 1000 securities trading on exchanges and Nasdaq. The study ran for roughly two years. After evaluating the data, the Commission proposed to eliminate any price test of any SRO as well as remove Rule 10a-1 from the Commission's rulebook. In July 2007, the Commission adopted its proposed rule change citing the results of the Pilot data. The Commission's Office of Economic Analysis ("OEA") argued that the data revealed no association between extreme price movements and price test restrictions.[5]

In its release eliminating the rules, the Commission expanded on this data analysis by claiming that: ". . . today's markets are characterized by high levels of transparency and regulatory surveillance. *These characteristics greatly reduce the risk of undetected manipulation and permit regulators to monitor for the types of activities that current price test restrictions are designed to prevent*."[6] Indeed, the Commission used this phrase twice in the same release to make its point that today's markets are far less susceptible to manipulative short selling.[7] The Commission obviously believed that exchange surveillance systems and general market transparency could detect manipulative short selling activity in a time frame that would permit the Commission to act against the perpetrators. Rapid enforcement action could act as a substitute for the preventive character of price test restrictions. Unfortunately, we believe the Commission was wrong in this fundamental premise. Over one year later, where are the enforcement actions? And even if enforcement actions are brought, they take years to litigate. The true benefit of price test restrictions, which the Commission acknowledged, is that they act to prevent harm before it occurs. We urge the Commission to reconsider the old adage: an ounce of prevention is worth a pound of cure.

Schwab believes the above quote exemplifies the Commission's overreliance on the market transparency and the sophistication of exchange surveillance systems to detect and prevent short sale manipulation. Certainly, the Pilot study informed their perspective, yet an overriding, misplaced presumption of transparency and certitude on the efficacy of enforcement smoothed the way for change. We believe that the bear raids in AIG, Lehman, Bear Stearns and many other financial stocks went undetected by exchange surveillance systems and remain to be sorted out by Commission enforcement staff years later. The surveillance systems did not, as the Commission claimed, "permit regulators to monitor for the types of activities that current price test restrictions are designed to prevent."

We believe that the absence of price test restrictions facilitated the bear raids, and we are not alone in that belief. Many market experts have called for the re-introduction of an uptick or bid test. George Soros, Chairman of Soros Fund Management, wrote earlier this year that: "[t]he unlimited shorting of stocks was made possible by the abolition of the uptick rule, which would have hindered bear raids by allowing short selling only when prices were rising."[8] Chairman Ben Bernanke of the Board of Governors of the Federal Reserve, stated in testimony before the House Financial Services Committee that: "[i]n the kind of environment we have seen more

---

[5] Securities Exchange Act Release No. 55970 (June 27, 2007), 72 FR 36348 (July 3, 2007) at 36351.
[6] *Id.* at 36351 (emphasis added).
[7] *Id .at 36355.*
[8] George Soros, *One way to Stop Bear Raids*, Wall Street Journal, March 23, 2009.

recently, the uptick rule may have had some benefit."[9] And as our Chairman and founder, Charles R. Schwab, wrote in December; "[i]ronically, it was just this sort of volatility that inspired the regulators of the 1930s to implement the uptick rule in the first place. Without this vital control mechanism, short sellers have been having a field day, betting heavily on lower prices and triggering panicked investors to sell even more."[10]

Commissioner statements at the open meeting proposing the possible re-introduction of price tests make clear that economic data must inform any Commission action. Chairman Schapiro stated that: "[i]t is important that we obtain informed public comment before determining whether or not to impose any short sale restrictions, and if so, what those restrictions should be."[11] Commissioner Paredes stated: "It is not self-evident that the findings of these economic studies – which supported this agency's prior decision to repeal the "uptick" rule – do not continue to hold in the current economic and financial climate."[12]

OEA conducted its Pilot study of the effectiveness of short sale price test restrictions during a period of slowly rising prices with low volatility and little fear of issuer collapse. Importantly, the study found that price test restrictions reduced the volume of short sales as compared to total volume, or as the study stated: "price restrictions affect the ability of short sellers to demand liquidity by getting prompt execution of market orders."[13] We think this is exactly why the markets benefit from uptick or bid tests. Placing constraints on the ability to sell short protect investors against the threat of manipulative trading. Short selling has the potential to drive prices down and self-validate the perceived weakened financial condition of an issuer. George Soros termed this effect "reflexivity,"

> "which means that the mispricing of financial instruments can affect the fundamentals that market prices are supposed to reflect. Nowhere is this phenomenon more pronounced than in the case of financial institutions, whose ability to do business is so dependent on trust. A decline in their share and bond prices can increase their financing costs. That means that bear raids on financial institutions can be self-validating."[14]

Others hold similar views. In their paper, "Manipulation and the Allocation Role of Prices," Professors Goldstein and Guembel showed: "how traders who deliberately drive the share price down can undermine the firm's health, causing the share price to fall further in a vicious cycle. 'What we show here is that by selling [the stock], you have a real effect on the firm,' Goldstein notes. 'The connection with real value is the new thing. . . . . That is the crucial element.'"[15]

---

[9] Bloomberg.com, February 25, 2009.
[10] Chuck Schwab, *Restore the Uptick Rule, Restore Confidence,* The Wall Street Journal, December 12, 2008.
[11] Chairman Mary L. Schapiro, Opening Statement Before the U.S. Securities And Exchange Commission Open Meeting on April 8, 2009.
[12] Commissioner Troy A. Paredes, Statement Before the U.S. Securities and Exchange Commission Open Meeting on April 8, 2009.
[13] OEA study: "Economic Analysis of the Short Sale Price Test Restrictions Under the Regulation SHO Pilot)dated February 6, 2007) at 6.
[14] George Soros, One Way to Stop Bear Raids, The Wall Street Journal, March 23, 2009.
[15] Itay Goldstein, Wharton School, U of P, and Alexander Guembel, Said Business School and Lincoln College, Oxford University, "Bear Raid" Stock Manipulation: How and When it Works, and Who Benefits, *Knowledge@Wharton,* April 16, 2008.

Some will argue that price tests degrade the efficiency of markets. Stocks should be allowed to move wherever the buyers and sellers send them. But when market movements change the financial health of a company, *i.e.,* are self validating, the efficient market theory no longer holds true. Short sellers may manipulate a stock lower and ultimately create the reality that the company is in trouble. Long-term investors are forced to liquidate their positions at manipulated prices. If the Commission were correct that exchange surveillance systems could detect this action, there would be no need to apply a prophylactic mechanism to protect investors from these raids. Detecting manipulation and taking enforcement action, however, is not an easy or swift process and it is not a process that can prevent short sale manipulation. Having a rule that creates friction on downward price movements, thereby making manipulative short selling more difficult and costly, is the appropriate choice of an agency charged with protecting investors.

Circuit Breaker Approach

Schwab urges the Commission not to adopt the proposed circuit breaker approach in any of its varied forms. We believe that short sale regulation should apply market-wide and full-time. Invoking short sale regulation only upon a "severe decline" in a security, as alternatively proposed by the Commission, seems likely to permit the very panic that the short sale price restrictions are designed to prevent. As the price of a security drifts lower, short sellers will become concerned that the costs of shorting will rise once the circuit breaker is triggered so they will rush to sell short prior to reaching the trigger. This so-called "magnet" effect increases the likelihood of triggering the circuit breaker and with it the stigmatizing impact of being down so significantly that the trading rules must change.

Should the Commission adopt the circuit breaker approach, we would prefer to see the triggered restriction be the bid test. We have expressed our preference for the bid test in this letter and believe it is the better regulatory approach. We also believe that the worst approach would be to impose a short sale ban once a stock triggers the circuit breaker. Banning short selling altogether can result in anxiety about where the security will trade once the ban comes off, with the potential for greater price volatility through pent up short selling pressure. While we understand that market participants have claimed that a circuit breaker approach with a short ban is the easiest to implement from a programming perspective, we urge the Commission to focus more on the importance of regulation rather than ease of its implementation.

Specific Questions

With respect to price tests, is a tick-based test still practical in a Regulation NMS trading environment?

While we don't believe that Regulation NMS has anything to do with our point of view, Schwab believes that a last sale or "tick" based test is no longer the optimal solution to short sale price test restrictions. We believe that the non-sequential nature of trade reporting to the consolidated tape alone makes use of the last sale price unworkable. The ability to short sale can be held hostage to aberrant trade prices because trades, which can be reported up to 90 seconds after execution, will show up on the consolidated tape after they no longer reflect the current market.

If no exception applies, a last sale on or above the national best offer could preclude the execution of a short sale at any price on or between the national best bid or offer. In effect, short sellers could be frozen out of the market. We note, however, that this problem with the Uptick rule predates Regulation NMS.

On the other hand, a Bid test provides the important anti-manipulative impact by preventing short sellers for exhausting successive bid price levels all the while greatly enhancing the ability to execute short sales above bids. The rule permits short sellers to effect short sales at any price above bids including between the bid/offer spread or on the offer. The Bid test also eliminates the need to determine what an appropriate tick for executing short sales is. Some have claimed that 2, 3, or 5 Cents is an appropriate tick. When the prescribed conduct is hinged on bids, this decision need not be made.

Would a policies and procedures approach be preferable to a straight prohibition on short selling at an impermissible price?

We encourage the Commission to implement a Bid test under a policies and procedures approach. We believe that this mechanism, adopted with respect to trade-through prohibition in Regulation NMS, works well and can be effectively enforced.

Conclusion

We appreciate the Commission's effort to revisit the regulation of short selling, particularly in the context of restoring investor confidence. Often, we believe, retail investors are forgotten and ignored in the highly complex U.S. financial system, including its regulatory structure. But these investors have been severely harmed during the recent crises. Schwab believes that re-imposing a Bid test can significantly restore investor confidence and urges the Commission to move swiftly to put this important investor protection back in place.

Jeffrey T. Brown
SVP
Schwab Office of Legislative and Regulatory Affairs