Comments Regarding the Short Sale Price Rule

First of all I want to commend the Commission in its attempt to re-evaluate the existing exchange rules. This is certainly long overdue.

Regarding the short sale rule, I believe it would be a mistake to re-instate any rule that allows short selling only on a uptick. Curbs on large drops of say 10% or even 5% in a day might make some sense however. More importantly, stricter enforcement on delivery and borrowing requirements would be better still.

So why not allow short selling on a downtick? A marketable limit order would take at best a little longer to execute. Ever since decimalization we see plenty of upticks of a penny even on liquid stocks that are dramatically in decline. So an uptick rule has little or no effect in these cases at all. Since it is meaningless to say in an absolute sense that a stock has had an uptick when it is traded on multiple exchanges, many traders send out multiple orders that fan out to different liquidity providers, further increasing the likelihood of an execution. This might be less true for illiquid stocks, but stocks of this category do not dominant or drive the market.

So what is the real purpose of the uptick rule? It is presumably to control the "avalanche effect" of stocks being shorted only to generate more shorting and long selling which generates still more such declines. There are several conceptual problems with this reasoning however.

One problem stems from the claim that some traders attempt to drive down markets to make a profit – possibly by spreading rumors or through coordinated shorting among different hedge funds or institutions. We have all seen the James Cramer video in which he describes the process. However, such traders have already accumulated their short positions, and would have done so whether an uptick rule was in place or not. We already have laws regarding stock manipulation, although I know that such behavior can be hard to detect and enforce. More importantly, rumors often turn out to be just that, false information, so what was an attempt to profit on a stock's decline, turns out to be a buying opportunity for value traders. In fact the presence of short sellers is what permits them to buy the stock at a bargain price. So as long as the information is in doubt, there will be a restoring force in the market to bring the stock price back to a reasonable consensus. It is precisely this kind of price discovery that makes exchanges so essential to our economy. Of course some complain that such activity brings unwanted volatility to the market. But investors who have long term time horizons can safely ignore these daily fluctuations, while traders with a shorter time horizon knowingly trade at their own risk.

Another conceptual problem with short selling restrictions comes from the unwarranted need for some people to curb what they see as unnecessary high-frequency trading. What possible value is it in having traders who "buy in the morning and sell in the afternoon," as one commentator recently put it? Well, who are these people? Among them are options and derivatives traders who hedge their portfolios. Many of these options are essential tools in risk management – despite the bad rap that derivatives are receiving.

Others, such as arbitrageurs, also play an essential role in maintaining fair value among related securities. That fact that the uptick rule does not distinguish this group from speculators already shows that it is not consistent with what we know about market mechanics. Speculators on the other hand are essential as well. If the hedger is attempting to reduce risk by selling it, then someone must be on the other side of that transaction. Of course there are also the day traders, many of whom are amateurs working out of their home, but they qualify as a small influence in the scheme of events. So what is the ultimate value of this kind of trading? It provides liquidity, which shows up as a more narrow bid-ask spread. Now no one does anything without compensation, and imposing unnecessary restrictions on traders can only limit their participation, so keeping short sellers from making a profit would only impact liquidity and any widening of the bid-ask spread is effectively a tax on everyone.

The last conceptual problem has to do with a logical flaw in the uptick rule argument in regards to its lack of symmetry. If the objective is to limit short selling so as to reduce the damage of the avalanche effect, what about the damage of the asset bubble effect? A “pump and dump scheme” is probably just as common as a panic scare produced by rumor mongering, and even more naturally occurring bubbles can harm the late arrivals buying at the top. So would the SEC suggest there be a downtick rule as well? Once you follow through this logic, it becomes clear that micromanaging the market in this way can only be detrimental to the normal price discovery process – volatile though it may be.

So what should be done? The most obvious need is to insure that anyone who shorts stock must have actually borrowed it. Now anyone who sets up an E*Trade account can be sure that the stock they are borrowing is legally available, so the problem lies with hedge funds that are self-clearing and are claiming to possess borrowed stocks that they do not have. The result? There are cases where the short interest in a stock has exceeded its float! So this is where the SEC can crack down, with heavy penalties. As far as the curbs or circuit breakers, most short sellers do not keep shorting even if the stock continues to fall for fear of the upcoming short squeeze, so adding this rule will have little effect either, although it might allow more time for information about the market or company to be absorbing. Trading halts of this kind are already available however.

I am also aware that the SEC lifted the uptick rule and shortly there after we saw a large market decline. Do we actually believe that the market would not have fallen as far as it did had the rule remained in effect? The banking industry had made egregious errors, and the dramatic decline in their stocks was well deserved and predictable. Much of the amplification of the loss, if there was any, was probably attributable to the swap market, which of course should be regulated. May I suggest that, as an aside, that derivative markets, once they achieve a certain notional size, must be traded on an exchange, with appropriate collateral limits? That allows financial institutions to innovate and test market new products privately, and then, if successful, have them move to an exchange with greater transparency. Prohibiting products to be produced because they are “too complicated” is clearly wrong, as there was a time when ordinary options were considered rocket science, requiring math Ph.D’s to understand them (I know because I was one of them). Today such derivatives are an essential component to our markets.

I want to thank the SEC for inviting these comments. Doing so has definitely raised the confidence level of our government in its oversight efforts.

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