Martin B. Napor

June 17, 2009

Chairman Mary L. Schapiro
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File Number S7-08-09

Dear Chairman Schapiro:

Thank you for providing a forum for public comment on possible restrictions on short selling. I admit that I didn't read all 273 pages of your release but I did notice that you would like to see empirical evidence to support points of view. I have done research in this area and I'm happy to provide it to you.

I am a longtime value-oriented investor. I hold two graduate degrees – one in Applied Math and the other in Finance. I have done some short selling over the years – all on upticks and with properly borrowed shares.

My point of view is that some short selling is useful, particularly when stock prices are rising rapidly without regard to the fundamentals. An uptick rule is not incompatible with legitimate short selling. I fear that a one cent uptick rule will be inadequate in preventing the sort of damage we have witnessed in the past 20 months. I hope that I can persuade you to implement a stronger price test than what you are currently considering.

The work of Robert Barro of Harvard and J.F. Ursua is quite sobering. Their study of macroeconomic crises in numerous countries over a 130+ year span implies that the greater the decline in a country's stock market the greater the probability of an economic depression.

With the Barro study in mind, I examined the annual total return (price change + dividends) for the S&P 500 for the years 1926 through 2008. The uptick rule was not introduced until 1938 and as far as I know an uptick was 1/8 of a dollar or 12 ½ cents from 1938 until the late 1990's when the transition to decimal pricing began. I separated the data into two groups. Group A consists of the 60 years from 1938 through 1997. Those are the years when the uptick rule was the strongest– at least 12.5 cents per share. Group F contains all of the other years - 1926 through 1937 and 1998 through 2008. The uptick rule during the Group F years was either nonexistent or watered down to 6.25 to 1 cent per share.

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Within Group A, the years with a negative total return were segregated for further analysis. If negative total returns occurred in consecutive years, those years were chained together to calculate a cumulative negative return for the multiyear period. The same was done for Group F (See Table 1).

Table 1
Negative Total Returns

Group A (Strong Uptick Rule: 12.5 cents)		Group F (Nonexistent or Weak Uptick Rule)	
1939-1941	-20.6%	1929-1932	-64.2%
1946	-8.1	1934	- 1.4
1953	-1.0	1937	-35.0
1957	-10.8	2000-2002	-37.4
1962	-8.7	2008	-37.0
1966	-10.1		
1969	-8.5		
1973-1974	-37.3		
1977	-7.2		
1981	-4.9		
1990	-3.2		

	Group A	Group F
Average Negative Total Return	-10.95%	-35.00%
Median Negative Total Return	-8.5%	-37.0%
Years of Data	60 years	23 years
Years of Negative Total Return	14 years	10 years
Instances of –30% or Worse Negative Total Return	1	4

Table 1 shows the dramatic contrast between Group A and Group F. The average negative total return for Group A was only –11% while Group F was –35%. The fraction of years with a negative total return is significantly lower for Group A than for Group F (about 4 standard deviations). The occurrence of –30% or worse negative total returns was significantly higher for Group F than for Group A (about 6 standard deviations). My analysis of the data makes me state that there is sufficient empirical evidence to conclude that a strong uptick price rule (12.5 cents) results in a lower frequency of negative total return and, if a negative total return occurs, a much lower chance that it will deteriorate to a worse than –30% level.

I sympathize with all those who were harmed by the excessive drop in stock prices. Consider the people whose retirement savings and other savings were crushed. Consider the companies which have to divert cash flows to fund defined benefit plans and those whose reduced equity market value reduces their ability to borrow funds for expansion. Think of the non-profit institutions which have to reduce their budgets and good work. Think of the negative feedback as companies and families, feeling poorer, cut their spending and further reduce corporate profits, employment and personal income. If that doesn't influence you, then think about the tax revenue that isn't going to come in and the hundreds of billions of dollars the Federal government felt compelled to spend. The stock market is not a leading indicator for no reason at all.

I urge you to recognize the stabilizing influence a strong (12.5 cents) uptick rule can have on the stock market and the economy. How can you implement a strong uptick rule similar to the one that served the U.S. equity market so well for 60 years? I have a few ideas.

The simplest stronger uptick rule (call it Rule S) to understand, implement and comply with would be a requirement that the price of a stock is at least 12 cents higher than the previous day's closing price before a short sale can be made. This should be combined with whatever one cent uptick rule you decide on. In other words, there is a zone, beginning at a price 12 cents higher than the previous day's closing price and extending to the sky, in which a short sale on a one cent uptick is permitted. For stocks priced between $80 and $300 per share, I recommend a 25 cent margin above the previous day's close and for stocks priced above $300 per share a $1 margin.

A more complex uptick rule (call it Rule C1) that more closely resembles the Group A rule that worked well for 60 years might be harder to understand, implement and comply with since it involves time limits. For the first 20 minutes of trading, Rule C1 is identical to Rule S. After 20 minutes of trading, the real time price is compared to the price 15 or 20 minutes earlier (whichever is more widely disseminated by the exchange). If the real time price is at least 12 cents higher than the delayed price, a short sale is permitted. If not, then short sellers have to wait until this condition occurs. As with Rule S, for higher priced stocks a higher hurdle above the delayed price might be warranted (e.g., 25 cents for stocks priced $80 to $300 and $1 for stocks priced above $300).

A slightly less restrictive variation on Rule C1 (call it Rule C2) would be more acceptable to short sellers and may be best because bubble prevention is a legitimate goal as well. Rule C2 is identical to Rule C1 until a short sale is permitted. The price at which the short sale is first permitted becomes the floor of a short selling zone that extends to all higher prices. The only other requirement in the zone is a one cent uptick. The floor of the short selling zone could be lowered during the trading day if the stock price falls sufficiently below the existing floor and then rebounds far enough (at least 12 cents) and fast enough (within 15 or 20 minutes).

If you would like additional ideas from me about possible uptick rules feel free to contact me.

In addition to a strong uptick rule, I believe that investors need protection from some bad practices. There was a time when a glance at the monthly short interest statistics would show some stocks with a short interest greater than the shares outstanding. This hasn't happened recently so keep up the good work against naked short selling.

I also think that there should be no exceptions to complying with a strong uptick rule – no exceptions for hedgers, options traders, options dealers, futures traders, futures dealers, swaps traders, swaps dealers, index funds, exchange traded funds, mutual funds, hedge funds or anyone else I forgot to mention. Nobody!

Persuading foreign stock markets to join us in protecting investors would be good. If any foreign market becomes a rogue threat, U.S. companies can consider delisting from that market if they deem it to be in the best interest of their shareholders.

In summary, there is sufficient empirical evidence to conclude that a strong uptick price rule (12.5 cents) results in a lower frequency of negative total return and, if a negative total return occurs, a much lower chance that it will deteriorate to a worse than –30% level. Several possible strong uptick rules were presented in the context of a world with one cent ticks. Other measures to protect investors from predatory practices were mentioned.

I hope that my comments were useful to you and helpful in restoring the U.S. equity market as an institution that provides good returns to investors, capital to companies with good expansion ideas, opportunities to short sellers who can identify overpriced stocks and increased confidence to all Americans.

Sincerely,

Martin B. Napor