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Securities and Exchange Commission
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Dear Securities and Exchange Commission:

Here are my comments on the latest Regulation SHO proposal that proposes additional restrictions on short selling such as a price test and/or a circuit breaker:

- The SEC is in grave danger of missing the big picture. The real issues are 1) excess short-term volatility and 2) potential manipulation by short sellers.
- The proposals deal only crudely with the short-term volatility issue and do almost nothing to deal with the potential for manipulation.
- The Commission should work towards a “shock absorber” to deal with excess short-term volatility. One possibility is a Deutsche Börse-style “volatility interruption”: After a significant move (up or down) followed by a call auction to re-open the stock after a human checks to make sure that there is no reason for a further delay.

- We need better transparency with regard to short sales. The Commission should reinstitute the requirement that exchanges release trade-by-trade short sale data. This needs to be done before any changes so that everyone can observe the impact of the changes.
- The SEC should make it a standard practice to pay explicit attention to what the rest of the world does in its rulemaking procedures. We can learn from the successes and mistakes of others.

This rulemaking is a response to the uproar over recent events in our financial markets. Investors burned by the volatility associated with the market meltdown sense that there is something wrong in our market structure and are screaming for changes. Many of them note that market volatility increased shortly after the removal of the last vestiges of the old and useless uptick rule. It is natural to jump to the erroneous conclusion that the removal of the old uptick rule caused the increase in volatility. The old rule was carefully studied in a well-designed experiment. I personally examined the pilot data and came to the same conclusions as others did: the old rule was a sham that did no good for the markets. It was harmful in that it provided a false sense of security to investors and resulted in a large misallocation of resources into complying and enforcing an unnecessary rule.

The Commission has been deluged with thousands of comments, many of which show little understanding of the operations of our markets. Bringing back a useless rule just to appease this reflexive cry of pain would do more harm than good. Instituting a useless rule just for show would send a really bad signal to the capital markets that our regulators will take stupid actions out of short-term political expediency. This would seriously damage the reputations of all of the individuals and institutions involved.

Despite the ignorance of many of the commenters, they should not be ignored. Although their prescription to bring back the old useless uptick rule is wrong, they do have legitimate concerns about our current market structure. I beg the Commission to think outside the box and ask what the real problems are.

Our electronic markets lack a shock absorber.

Most electronic exchanges around the world have automated systems in place to deal with extreme events. We don't. High speed algorithmic trading has brought amazing liquidity and low transactions costs to the markets, but it also brings the risk of market disruption at warp speed.

Our markets are vulnerable to short-term fluctuations that can result in prices that do not reflect the market's consensus of the value of the stock. The disruption in the trading of Dendreon (DND) on April 28, 2009 that I referred to in my remarks at the Roundtable is a smoking gun. (My remarks are repeated at the end of this comment letter for your convenience as well.)



The stock plunged for no apparent reason, and by the time the humans halted trading the damage was done. Many investors who had placed stop-loss orders discovered that their orders had been filled at very low prices. Furthermore, incidents like these bring up suspicions of foul play, and these suspicions hurt our capital markets. When investors think that market manipulation is unpunished, they will withdraw from our capital markets, reducing their usefulness to our society.

Short selling is not the only cause of short term market disruptions.

A burst of short selling can cause a “Dendreon moment”, but so can long selling. Markets can also be disrupted on the up side as well. In considering what to do about situations like this, the Commission should consider the broader needs of the market for a shock absorber to deal with excessive short-term volatility.

The Commission should actively consider shock absorbers that deal with ALL price disruptions, not just ones triggered by short sales. One time-tested model to consider is the “volatility interruption” used by Deutsche Börse.¹ When the stock moves outside of a reference range, trading is halted for a period of time and trading then restarts with a call auction.

We need not follow the Deutsche Börse model exactly. Short orders at prices below the previous opening or closing price could be excluded from the restarting auction (with appropriate exemptions for market

¹ http://deutsche-boerse.com/dbag/dispatch/en/binary/gdb_content_pool/imported_files/public_files/10_downloads/31_trading_member/10_Products_and_Functionalities/20_Stocks/50_Xetra_Market_Model/marktmodell_aktien.pdf

makers and arbitrageurs). After trading restarts, restrictions should be placed on short sales at prices 5% or more below the previous opening or closing price to maintain fair and orderly trading. These could include 1) preborrowing requirements or a bid test.

Any changes should be carefully studied with a transparent pilot experiment.

Before the Commission institutes any such changes, it should experiment carefully as it did with the original Regulation SHO pilot. In this way, the Commission could adopt the best of the different proposals after carefully examining their impact.

The Commission should reinstate the requirements for exchanges to release trade-by-trade short sale data.

During the Regulation SHO Pilot Experiment, the Commission required exchanges to release trade-by-trade short sale data. These data provided an excellent window into the role of short selling in our markets. Dropped this requirement at the end of the Pilot was a major mistake. Without good data, how can investors judge for themselves what is going on?

Adding a short sale indicator to existing data feeds would not be an insuperable task. Existing data feeds already have a field indicating special conditions or trade modifiers. These existing fields could be used to also indicate short sales without expanding the bandwidth requirements.

It is particularly important that this transparency be implemented BEFORE any changes are instituted so that market observers can examine the effects of any such changes.

The SEC should pay attention to what other jurisdictions are doing.

It is a chilling indictment of the SEC's regulatory thinking that the 273 page rule proposal does not mention the European Union, Germany, Japan, or the United Kingdom even once. The U.S. is not the only country struggling with issues of short-term volatility and short selling. We can learn from the experience of other countries. All major rule proposals should explicitly examine the experience of other jurisdictions so that we are not always attempting to reinvent the wheel.

Respectfully submitted,

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Previous comment letters by James Angel, Georgetown University, on short selling and Regulation SHO:

<http://www.sec.gov/comments/s7-20-08/s72008-521.pdf>

<http://www.sec.gov/comments/s7-19-07/s71907-117.pdf>

<http://www.sec.gov/comments/s7-12-06/s71206-266.pdf>

<http://www.sec.gov/comments/s7-21-06/s72106-35.pdf>

<http://www.sec.gov/rules/proposed/s72303/jjangel011004.htm>

Opening Remarks of

James J. Angel, Georgetown University

SEC Roundtable on Short Selling

May 5, 2009

Summary:

- The original pilot study to examine the effects of the old uptick rule was well designed.
- The Commission did the right thing in removing the old uptick rule because it was useless.
- Short sellers did not cause our current financial problems, but there are legitimate reasons to be concerned about short selling.
- Proponents of restoring the uptick rule are really asking for a shock absorber to reduce excessive volatility and prevent more Dendreon incidents.
- Our markets need such a shock absorber to improve the price formation mechanism.
- Better transparency with respect to short selling is essential for preserving the market's reputation for integrity.

We are here today because of the uproar over short selling in our financial markets during the recent financial debacle. Short selling has been controversial for over 400 years since modern equity trading began in the shares of the Dutch East India Company. And I am sure that it will remain controversial for the next 400 years.

The original pilot study to examine the effects of the old uptick rule was well designed.

I have been very quick to criticize the SEC in many areas, but the decision to remove the old uptick rule is one area in which the SEC and its staff deserve much praise. As part of the Regulation SHO process, the SEC conducted a very careful empirical examination of the effect of the old uptick rule (Rule 10A-1) and the similar NASDAQ bid-test. This approach was a shining example of how to do regulation right with a scientifically designed controlled experiment. Approximately 1,000 of the largest 3,000 stocks were selected as pilot stocks, and they were matched with 2,000 similar control stocks. The old uptick rule or bid-test was eliminated for the pilot stocks but not the controls, and this experiment ran for over two years. The data were made publicly available and were examined by many parties.

The Commission did the right thing in removing the old uptick rule which was useless.

I personally examined the data myself and came to the same conclusions as other researchers: The old rules did nothing. One needed a very powerful microscope and to squint very hard to see any difference in behavior between the pilot stocks and the control group. There was no economically meaningful

difference between the two groups. It made no sense whatsoever to maintain a costly rule that did nothing, so the Commission did the right thing to get rid of it.

Alas, this experiment just happened to occur during a period that Federal Reserve Chairman Ben Bernanke called “The Great Moderation,” a time when volatility in the equity markets fell to levels approximately half of the historical average. Nevertheless, there were plenty of cases during that time during which individual stocks experienced volatility. The last vestiges of the old uptick rule were removed in the summer of 2007, just before the markets began to realize the extent of the financial problems emanating from the mortgage markets. Volatility returned with a vengeance, and it increased for the pilot stocks just as it did for the stocks freshly released from the old uptick rule.

Short sellers did not cause our current financial problems.

Many observers blame the removal of the old uptick rule in 2007 for the upsurge in market volatility and are calling for a return of some type of restrictions. They are committing the logical fallacy of “*post hoc, ergo propter hoc*.” (“After this, therefore because of this.”) It is an unfortunate coincidence of timing that the last vestiges of the uptick rule were repealed just as the markets began to melt down.

The short sellers did not cause our current financial debacle. The short sellers did not force lenders to make millions of bad loans to deadbeats who couldn’t pay them back. The short sellers did not force the rating agencies to stamp AAA on billions of dollars worth of bad paper. The short sellers did not make Fannie Mae and Freddie Mac purchase billions of dollars worth of bad paper. Indeed, our current financial crisis might have been alleviated if we had had more short selling instead of less. If there had been more short selling of the now “toxic” securities and the firms that trafficked in them, it might have set off the alarms early enough to avoid the worst of the meltdown that occurred.

Nevertheless, there are legitimate reasons to be concerned about short selling.

However, critics of short selling do have three legitimate concerns:

- 1) Market mispricing on the down side is more damaging to the economy than on the upside. If a company’s stock is trading below its true value, then it is more expensive for the company to raise the capital needed to fund economic growth. In extreme cases, an excessively underpriced stock can demoralize employees, drive away customers, prevent access to capital, and destroy an otherwise productive enterprise.
- 2) Too much short selling too quickly may exhaust the liquidity available in the market. This can cause the price to drop below its true value, harming those who have placed stop loss orders. Excess volatility in the stock may scare away investors. If there are hysteresis effects in the market, there could be a long-lasting drop in the value of the stock.

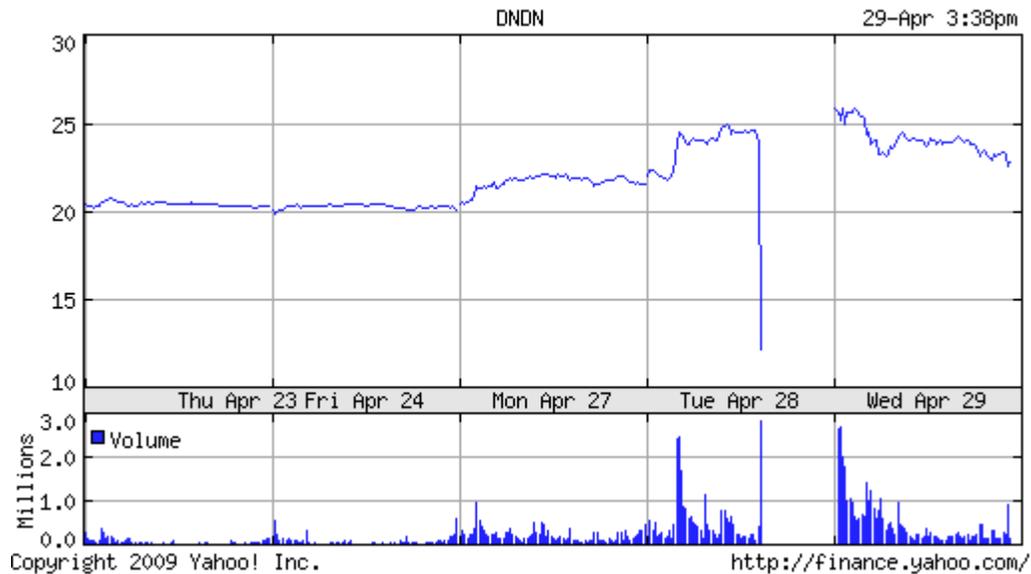
- 3) Short sellers have an incentive to spread misinformation and interfere with the operations of companies. The most egregious example of this was the Contac poisoning case in which an options trader tampered with the product and sought to profit from the impact of the tampering on the stock price.²

We need a shock absorber to prevent another Dendreon.

Those calling for a return of some type of uptick rule are expressing a legitimate concern. They intuitively grasp that there is something wrong with short-term price formation in our markets today. The recent incident with Dendreon (DNDN) on April 28, 2009 demonstrates the need for a shock absorber. The company was about to make an announcement regarding the effectiveness of its prostate drug Provenge. The stock plunged 69% in less than two minutes.³ After the news was revealed, the stock quickly returned to its previous levels. Investors who had placed stop loss orders to protect themselves found that their orders were executed at very unfavorable prices. Why did the stock plunge? It is too early to tell. Was it a “fat fingers” mistake in which an investor hit the wrong button? Did an algorithm misfire? Was it a chaotic interaction between dueling algorithms? Did a long seller panic and dump too many shares too fast? Was there a deliberate “bear raid” manipulation going on from informed traders hoping to push the price down so they could trigger stop loss orders and scoop up shares cheaply? Or was it just the case that the market was very thin just before the news announcement and a few large sell orders exhausted the available liquidity, triggering the selloff? Regardless of the reason, the incident demonstrates the need for a shock absorber to deal with extreme situations.

² See New York Times, October 31, 1986, “27 Years in Poison Case”, [http://www.nytimes.com/1986/10/31/us/27-years-in-poison-case.html?n=Top/Reference/Times%20Topics/Subjects/S/Sentences%20\(Criminal\)&scp=3&sq=Edward%20Arlen%20Marks&st=cse](http://www.nytimes.com/1986/10/31/us/27-years-in-poison-case.html?n=Top/Reference/Times%20Topics/Subjects/S/Sentences%20(Criminal)&scp=3&sq=Edward%20Arlen%20Marks&st=cse)

³Ortega, Edward, Nasdaq Will Let Stand Dendreon Trades Under Review
<http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a314cxKBoGHI>



The era in which humans traded with humans is long gone. Now computers trade with other computers in the blink of an electron. Most other developed equity markets around the world have some kind of procedure for dealing with extreme situations. Whether it is a price limit, a trading halt, or a special quote mechanism, the United States needs to install a shock absorber to deal with excessive volatility. One of the main purposes of the stock market is to provide good price discovery. If the price discovery mechanism appears to be broken, it will reduce investor confidence in the market.

Unfortunately, merely reimposing the old useless uptick rule or forcing a pre-borrow for shorted shares will not solve the problem of excessive intraday volatility. What is needed is to think outside the box of “lets get the short sellers” to the more useful question of “what kind of shock absorber works best in our modern markets?”

It is certainly not obvious what form such a shock absorber should take. One thing that is clear is that the 1939 uptick rule will not achieve the objective of reducing excess volatility. Installing a broken shock absorber from a 1939 Chevrolet Coupe into our 2009 Corvette market will not do the job. What would make sense is a dampener similar to the exchanges’ proposal. The beauty of the exchange’s circuit-breaker with restriction idea is that it does not interfere with normal market operations under normal conditions. It only kicks in when needed, at times when the market is under stress. Perhaps a more gradual shock absorber would make more sense. For example, one approach would be:

- At prices at or above 5% below the previous close: No restrictions
- At prices below 5% below the previous close: Hard preborrow for short sales
- At prices 10% below the previous close: price test for short sales
- If the price hits 20% below the previous close: Automatic 10 minute trading halt. The stock would reopen with the usual opening auction after market surveillance has determined that there are no pending news announcements.

I urge the Commission to begin consultation with the industry to develop one that fits the unique and competitive nature of our markets. If nothing is done, there will be more Dendreons.

Better transparency with respect to short selling is needed.

Whenever there is a major market movement, there is a natural tendency to blame misdeeds by short sellers. For example, was the recent avalanche in Dendreon set off by the short sellers? Was there rampant naked short selling? The public does not have the information to make its own determination. The repeated enforcement lapses at the SEC over the years do not give investors much confidence that the regulators will find out what occurred and take appropriate action.

Unfortunately, the Commission did bleep-up royally when it failed to extend the public data dissemination on short selling that was part of the pilot experiment. This means that there is no way for the general public to observe the extent of short selling in our markets. The Commission should enhance transparency with respect to short selling in the following ways:

- Real-time data feeds should contain a condition code indicating that the seller was short. The exchanges already track this information. Existing data feeds already have special condition codes, and these can be used to flag short trades without the need for extending the data fields.
- Short interest data in individual stocks should be released weekly, if not daily. It would make sense to do this with a seven day lag to protect confidential trading information.
- Settlement failure data should be released no more than one week after the settlement date. Currently, the SEC releases this data long after the quarter has ended. Releasing this information on a timelier basis would alert the market to any problems with respect to settlement.