Dialectic Capital Management LLC

June 18, 2009

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F. Street, NE
Washington, DC 20549-1090
Via email: rule-comments@sec.gov

Re: Amendments to Regulation SHO

Dear Ms. Murphy:

We believe that the SEC has a statutory responsibility to be, and has a long history of being, data driven in its rule-making mandate. We respectfully submit that there is, as far as we know, no empirical evidence supporting the adoption of an uptick rule and there is ample evidence against the adoption of such a rule. While we support a permanent implementation of rule 204T (regarding failure to deliver) and rule 10(b)21 (regarding false representation of an ability to deliver), we strongly oppose all of the proposals regarding short selling restrictions. We have encapsulated all the data of which we are aware and combined them into four main points:

1. The notion that the absence of a tick test caused the start of the market decline in July 2007 is demonstrably false. Short selling activity actually dropped after the uptick rule was eliminated.
2. Short sellers were not significant net sellers of financial stocks in the weeks leading up to the ban in October, leaving the claims of aggressive short selling without merit. In fact, short selling volume was one half of the norm, which means that long selling must have been necessarily the source of the decline.
3. Financial stocks traded lower with the market both before and during the ban, making it virtually impossible that short selling was the cause of the declines.
4. Unrestricted short selling benefits the markets through better pricing and lower volatility. Restrictions on short selling lead to the opposite.

If an uptick rule is considered, we believe that it should be studied meticulously before it is enacted and it should include a sunset provision, in case the mechanism chosen does in fact turn out to be damaging to markets. Additionally, we believe that allowing political interference with technical aspects of the market in the name of "populist rage" is dangerous and unwise. This is why the SEC has, for decades, acted as an expert agency, informing both the public and the politicians as to the potential and unintended market impacts of changes to market rules. We ask only that the SEC continues to play this role and at the very least, carefully examine the market impact of any proposals before enactment.

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The idea that the absence of a tick test caused the collapse is perhaps the most widespread misconception regarding the removal of the uptick rule. It has been incorrectly assumed that the repeal of the rule in July 2007 influenced the market decline soon after.

According to Credit Suisse analyst Ana Avramovic, "Perhaps surprisingly, short interest on the NYSE (number of shares sold short compared to total shares outstanding) actually declined after the short sell restrictions were removed!" Ms. Avramovic goes on to say that "short interest peaked in July 2007 when the uptick rule was removed then proceeded to decline to November. This appears to confirm that shorts did not flood the market simply because they were able to trade freely. Rather shorts seem to be simply expressing bearish market views." While the fact that short selling *decreased* after the uptick was removed may surprise and confound those calling for the reinstatement of the uptick rule, it makes perfect sense to market participants. There is simply no reason for an economic actor to sell low and buy high. Here, fearmongers may respond, "Yes, but in a bear raid, short sellers try to create a run on the bank." As market participants for over a decade, we have never witnessed, been a part of, or even heard of a "bear raid" on a company. If the mythical bear raid does exist, it is almost certainly marginal and not worth a complete overhaul of thoroughly-researched market rules.

To argue that the market went down because of the repeal of the uptick rule is to ignore the collapse of Bear Stearns, the start of one of the most significant market declines in 100 years. These days, we talk more about Lehman Brothers than Bear Stearns, but the failure of Bear really began simultaneously with the removal of the uptick rule. According to the aforementioned Credit Suisse research piece, on June 14th, 2007, "Reports emerge[d] that Bear Stearns is liquidating its assets in a hedge fund that made large bets on the US sub-prime market." by June 25th Bear was forced to rescue a second hedge fund. By July 26th Bear Stearns seized the assets of one of its problem hedge funds, and by the 31st, Bear stopped clients from withdrawing cash from a third fund saying "it has been overwhelmed by redemption requests." By pure coincidence, the uptick rule was repealed on July 6, 2007, exactly in the middle of this unfolding crisis.

Finally, if it were true that the repeal of the uptick rule in the US caused the US equity markets to decline, that decline should have occurred *only* in the United States. That was not the case. Markets retreated on a global basis due to global macro economic weakness.

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We conducted our own analysis of the change in the bi-weekly short interest data reported to the NYSE in order to determine if there was a significant increase in short selling in those financial shares that were covered by the executive order on 9/18/2009 banning short selling. We took data from 8/29/2008 and 9/15/2008 and found that there was only a 1.9% increase (according to Bloomberg) in short volume leading up to the ban, hardly justifying the claim that there was aggressive short selling in the days leading up to the emergency order.

Looking more specifically at two companies alleged to have complained loudly to Treasury and the SEC, Goldman Sachs (GS) and Morgan Stanley (MS), "a quick look at the data for GS and MS suggest that Wednesday and Thursday might have been more about panicked longs than shorts. Specifically, for GS, 22.1% of DOT volume was executed by short sellers on Wednesday and 20.5% on Thursday; the median percentage for the balance of September and five other months was 40.0%. For MS, the numbers were 26.8% and 21.1% for Wednesday and Thursday, and 35.3% for the broader sample." (J. Selway 9/2008). In sum, in the two days leading up to the ban, short volume was one half of normal, which means that long selling must have been necessarily the source of the decline.

Furthermore, the total short exposure to Morgan Stanley currently represents less than 1.5% of the total shares outstanding. This measure (the short interest ratio) peaked at a de minimus 3%, in August of 2008 - hardly an onerous amount of short pressure.

<u>Financial stocks traded lower with the market both before and during the ban, making it virtually impossible for short selling to be the cause of the declines.</u>

If short sellers were responsible for the decline in the financial stocks, then presumably when short selling was banned the financial stocks should have gone up. They did not. In examining the performance of the Russell 3000 versus the restricted stocks - over the period before and during the ban, the restricted stocks fell in line with the market in the first two weeks of September, and again during the "crisis" week of 9/15 to 9/18. The surprising fact is that the stocks on the restricted list fell another 22% while short selling was disallowed, while the broader market fell 23%. This was definitionally all long selling and strongly supports the earlier data: that even the decline leading up to the ban was caused mainly by long selling and not short selling.

	First 2 weeks September, 2008	Crisis Week (9/15 – 9/18)	Short Sell Restriction Period (9/19 – 10/8)
Russell 3000	(2%)	(3.5%)	(23%)
Restricted Stocks	(1%)	(3%)	(22%)

A more scholarly study prepared by the EDHEC Business school in Nice, France in April 2009, reached the same conclusion stating that, "it is fair to conclude that neither the crisis nor the short sale ban had any impact on the extreme movements of markets or stocks."

<u>Unrestricted short selling benefits the markets through better pricing and lower volatility. Restrictions on short selling lead to the opposite.</u>

While academic studies supporting unrestricted short selling are numerous, studies that support the use of uptick tests are, as far as we know, non-existent. There is a reason no other nation in the world has an uptick test, and those that have experimented with it (Hong Kong) have repealed it, as we did domestically in 2007. Below, we cite some of our favorite statistics regarding the benefits of short selling, the negative impacts of uptick rules, and the market distortions introduced by short selling bans.

1. "Just as continued selling can unfairly push prices below their fair value, irrational exuberance can similarly push prices too high. However, we have no regulatory restraints on buying when prices are rising and there are no proposals to do so. Short sellers provide the only natural curb to this excess." - Credit Suisse (2009)

2. "Buyers transferred $4.9 billion more to sellers due to the inflation in the banned stocks during the banned period than they would have had the SEC not imposed the ban." - Harris, Namvar, Phillips (2009)

3. "On behavior of spreads when short sellers were banned from the financial stocks listed in the executive order "...average bid-ask spreads in the 950 names on the list are substantially wider than they were prior to the restriction, including during the "crisis week" of Sept 15-18. The "normal" average bid-ask spread for securities subject to the short sell restriction was around 17 bps in 2008. In the week following the restriction (Sept 22-26), they hovered around 40bps. By the end of the period, on Oct 8, the average spread was almost 60bps - nearly quadruple the average prior to the restriction!" - Credit Suisse (2009)

4. "Bris, Goetzmann and Zhu (2007) consider whether short-sale restrictions may be helpful during severe market panics, they analyze cross sectional and time series information from 46 equity markets and find that short sale restrictions do not have noticeable effects at the individual stock level. On the other hand, they find that markets with active short-sellers are informationally more efficient than those markets without significant short selling." - Harris, Namvar, Phillips (2009)

5. "The data showed that a one-cent increment would be restrictive for more than 60% of the short sales submitted. We also noticed that a five cents increment would be close to an outright ban on short selling for highly and moderately active stocks." - Office of Economic Analysis, SEC 12/17/08. *This is a fantastic example of the SEC responding wisely to a misguided idea with hard data.*

6. "The evidence gathered from the [SEC] pilot suggests little empirical justification for maintaining short sale price test restrictions" - Diether, Karl B.; Lee, Kuan-Hui and Werner, Ingrid M. (Augst 14, 2007)

7. "While short-selling activity increased both for NYSE and NASDAQ-listed Pilot stocks, returns and volatility at the daily level are unaffected...The results suggest that the effect of the price-tests on market quality can largely be attributed to the distortions in order flow created by the price-tests in the first place." - SEC Pilot Study

8. "…the execution quality of short-sell orders is adversely affected by the Uptick Rule, even when stocks are trading in advancing markets. This is inconsistent with one of the three stated objectives of the rule, i.e. to allow relatively unrestricted short selling when a firm's stock is advancing so that the rule does not affect price discovery during such times." Alexander, Gordon J. and Peterson, Mark A. "Short Selling on the New York Stock Exchange and the Effects of the Uptick Rule" - *Journal of Financial Intermediation* (January 1999)

A preponderance of data shows uptick rules and short selling bans are damaging to markets and we can find no data to the contrary. There is clear evidence that short selling *decreased* after the uptick rule was removed, arguing strongly that the decline in the market was due to the Bear Stearns collpase, not the repeal of the rule. As for short sellers exacerbating the decline in financial stocks leading up to the crisis, short interest did not meaningfully increase in the 1,000 financial names in which short selling was eventually banned, and in Goldman Sachs and Morgan Stanley stock, short selling was one half of the normal levels in the days leading up to the ban. Finally, and in further support of the prior point, financial stocks on the banned list fell in line with the market before the ban, and *during* the ban, making it virtually impossible to pin the drop in financial stocks on short sellers.

On a final note, we must comment on the proposed rule of disclosure of short positions. The idea that the management of public companies treat long sellers and short sellers identically is naive. We believe that access to company managements will be greatly reduced for any investor that shows up as "short" a company's stock. As a result, market efficiency will be similarly impaired. Furthermore, public disclosure would expose short sellers to very real and documented threats. Finally, if investors began to watch known short-selling firms and pile into their ideas, downward pressure could very likely be exacerbated by the visibility - a clear unintended consequence. For these reasons, we believe that the Form SH requirements should at the very least remain non-public. Preferably, the requirements should be allowed to sunset, as they are onerous for small firms and identical data is available at the exchange and the broker level.

We appreciate your attention.

Sincerely,

Luke Fichthorn
Managing Member

John Fichthorn
Managing Member