June 02, 2009

The Honorable Mary Schapiro
Chairman
100 F Street, NE
Washington, DC 20549

RE: Uptick Rule Reinstatement Comments

Dear Chairman Schapiro,

In all of the public discussion on short selling and reinstating the Uptick Rule, I have heard arguments that we need shorting for liquidity or the Uptick Rule to prevent “raids”. Any arguments that dare to suggest that we ban short selling are looked upon with disdain by the discussion in the media. All of these arguments have not addressed the basic question of whether short selling while currently accepted within the market system is actually right or should be legal. Beyond these facts, the most interesting and perplexing thing, about the arguments I have heard, is that the blame for our current market turmoil falls on the short sellers while the basic unspoken premise of the arguments remain that short selling is viable. Continually, it is assumed that we need short selling in the current form with only slight regulatory intervention. Well I would like to question conventional wisdom on this point. Furthermore, any argument for or against an Uptick Rule is side stepping the real issue. Short Sales introduce an imbalance in the auction based system of the stock market. This asymmetry cannot be fixed by allowing short sales to continue with minimal regulation. Reinstating the Uptick Rule in any form would only remove a portion of this asymmetry, and it becomes a patch rather than a solution. Again the real issue is the fundamental question of whether short selling, while currently accepted within the market system, is right and proper. Therefore I support the Uptick Rule while making the distinction that it is merely a distraction from the core issue, and would recommend a wider hearing on the practice of short selling.

One final point. When it takes 273 pages in the proposed rules document to describe the rules and all of the caveats, it seems to me there is probably a more serious problem that needs to be addressed.

Sincerely,

Jason Childs

Private Investor

Essays on Short Selling and Impacts on the Private Investor

In the following sections, I have in closed my thoughts on short selling as a private investor, myself, sees it. I have tried to do so in simple terms so that hopefully some ideas can be injected into the discussion on this topic. Whether you agree with the following analysis or not, I provide the following in the hopes it will expand the discussion on the Uptick Rule to include the fundamental question of whether short selling is right and proper. I do not purport to be an expert on finance, economics and legal matters, and I am sure some will dismiss this document on those grounds alone. I start with the basic premise that there is a fundamental difference between a system that allows investors to take calculated risks with the expectation of compensation, and a system that is biased against any investor.

Impacts on The Pursuit of Happiness

The pursuit of happiness is an inalienable right of every person. At the same time no one person or group, in their respective pursuit of happiness has the right to abridge this right for others. The question then becomes:

"Is short selling an abridgment to a person's right to the pursuit of happiness?".

Private property is just one item obtained by individuals with the goal of achieving happiness, thus a person is allowed to ensure that the value of that private property has protection against any manipulation by another person or group's pursuit of happiness. Stock exchanges provide a service as an equitable system that is used to facilitate the transfer of private property which in this case is stock certificates. Therefore any construct in the stock market system that provides a method of manipulation of private property value to any participant would abridge right to the pursuit of happiness for all participants. Short selling, however, is a mechanism by which the value of private property is decreased through the artificial creation of certificates by only a few people in the whole market. Regardless of the time frame in which this decrease to the value of private property occurs, it does occur and there is no absolute guarantee that the original value of the private property will be restored. The other problem is that if every person in the market utilized short selling, the market would not function thus dramatically demonstrating the effect short selling can have on the pursuit of happiness; therefore, at any given period of time in the market, there is only a subset of participants that can use short selling. This manipulation of the value of private property by another person or group abridges the right to the pursuit of happiness for any individual participating in the market.

To be absolutely clear on this point, everyone must understand that manipulation, as used in this discussion, covers the use of any artificial construct to devalue assets. It does not address whether life is fair, or that all companies should be run perfectly and always produce a profit. Life is not always fair and companies are not always run properly. These are the risks that every investor should be aware of and they are defined as natural or inherent risks. Here the right to the pursuit of happiness has no bearing on natural constructs and the inherent risks they create; however, the right does have application on artificial constructs that create imbalances in natural constructs, especially when they are used to create an inequitable advantage for any person or group. This includes any means of creating artificial supply or demand and skewing the natural function of the markets. Creation artificial constructs for any purpose have long been covered under regulations against manipulation. Except, the the creation of artificial certificates which provides an artificially larger supply, has somehow escaped the protection provided by these regulations.

There is also another point that is sure to be brought up in defense of short selling. Since short selling appears to provide liquidity and efficient pricing it is good for all market participants and therefore does a good for the group of market participants, regardless of the fact that it does abridge their rights. Besides this being an invalid argument because it assumes that an abridgment to any natural right of an individual is allowed, no effort has been expended trying other methods of providing liquidity and efficient pricing that do not abridge the rights of market participants. Until such effort is undertaken the current practice of short selling must be banned until all other methods that do not abridge anyone's rights have been tried and shown irrefutably to fail.

Company Stock as a Currency Model

A company's stock is just one part of the capital structure of a company. A certificate is the currency that the company is legally allowed to print outside of a government currency for the company's own purposes. The value of this corporate currency is backed by the assets and the products that a company produces. The expectation of any investor should be that the company revenues or the existing asset values are the basic factors for determining the initial intrinsic value of the company's currency. With the growth of a company the investor should expect an increase in that intrinsic value, and the currency value will increase with respect to the value of the government currency it was originally exchanged for. If a company does not produce revenues or the assets decline in value, the corporate currency value will decline with respect to the government currency value. Therefore, when an investor purchases stock, it is a currency exchange that takes place. By allowing a market to exist for exchange of these corporate currencies, other investors may decide to change their government currency for the corporate currency at a higher or lower exchange rate due to inherent value, inflation, future earnings expectations or other risk premium factors. Also, this allows for a balanced transaction since the act of buying or selling is always done as a pair. The balanced transaction is similar to the foreign exchange market transactions.

When discussed in terms of a currency model, short selling in the market is counterfeiting. In a normal stock short sale, the fake certificates are provided to the original owner's account, for a naked short sale, the fake certificates are provided to the secondary purchaser's account. This is the problem with inserting anything artificial in the middle of a naturally balanced currency pair transaction. If, however, the short seller's fake certificate is considered a separate binding contract to deliver real certificates, then it can not be considered counterfeit, with exceptions. Those exceptions include the requirement that the new contract based certificates cannot impact the current number of real certificates available since that would skew the real supply and demand. For this reason the certificate contracts must be traded outside of the stock certificate exchange system.

A Contractual Structure for Short Selling

As discussed in the previous section, by setting up contracts for short selling would remove the issue of skewing the actual number of certificates currently available for trading. A contractual structure for short selling must also preclude the transfer of voting and dividend rights that occur in our current system with short selling. The contract could be extended to allow only the dividend rights for a premium, but the voting rights should not be conferred on the buyer since they would not be the right of the seller to provide. This way the system also would prevent the usurping of voting rights that can occur by the purchasers of the short sold certificates. By the very fact that voting rights are currently transferred by short sales, we should ban short selling since it usurps what should be a fundamental right of every stock holder.

The voting rights issue is a problem, since hypothetically, allowing the borrowing and sale of certificates creates a situation that is almost unenforceable. This hypothetical situation is as follows:

An entity holds an aggregate deposit of certificates owed by different people with accounts at the entity. This pool can be sold to another single entity that wants a majority of voting rights and is willing and knows they will take a loss for projected greater future returns. The selling entity can then slowly procure the shares back on the open market at a lower price due to the apparent influx of new shares.

In this hypothetical situation, the original shareholders have lost their voting rights and there was a majority vote created. Obviously such an action would be covered under the market manipulation regulations, but the very fact that such a hypothetical situation can be constructed because of short selling is reason enough to address the issue of short selling head on.

Returning to the idea of contracts outlined above, there are already contracts similar to what was described and they are called options. They are superior to any contractual system that could be constructed to allow for the balanced short sale of stocks, since they do not intentionally introduce fake certificates into the market place. There are, however, further issues with options and the creation of short positions at their expiration. This problem is discussed in a later section.

Stock Markets as an Auction Model

In our current market, stock transactions can also be modeled as an auction process. A seller offers stock certificates for a certain ask price, while buyers provide bids for those certificates. Reserves can be set by either the buyer or seller using limit orders. When a short seller offers stock certificates for sale, the transaction is akin to offering a borrowed van Gogh painting for sale at a Sotheby's auction, while providing a print to the original owner without their direct knowledge of the transaction. In addition, because everyone at the auction believes that the original owner still has the original van Gogh, then that means that both are less valuable since there are now two in existence. A person owning a real van Gogh would obviously not allow this to happen, and the original owner would try to obtain some compensation for the destruction of value from the borrower unless it was returned with the same value.

Using the art auction as an analogy to the short sale transaction, the comparison shows that short selling breaks the transparency of the auction system and causes imperfect and hidden information to enter the auction, specifically additional, unaccounted for shares. One reason is because there is no information that tells you that your shares are now just copies, and there is no information that tells the new buyer that they are purchasing borrowed shares. This can lead to instabilities in the auction system and can produces a system similar to a casino where the odds are always in the house's favor.

Note that the market system is not advertised to the private investor as a casino, but that is the current state by allowing such hidden information. The term hidden information as used in this discussion is only meant to apply to information that is not disseminated to everyone at the same time. For example, corporate earnings information is provided to everyone at the same time even though it is hidden for a time, and access to that information before release is covered under insider trading rules. As an example of access to this hidden information, market makers are allowed to short shares to provide liquidity. They are the only ones that know there is strong buying or selling demand on a particular security, but there is no guarantee to the private investor that there is a firewall preventing the release of that information to other parties at different times. The short interest reporting provided by the exchanges is a start. Unfortunately it is an aggregate number released monthly and does not cover information on failures to deliver. To work properly in the auction system, the information on short sales needs to be updated instantaneously and provided to all market participants. This would ensure that the increase in shares is correctly accounted for by the bidders in the market and not interpreted as false selling pressure by the real holders of the security.

If removing short selling completely from the system does cause a liquidity issue and a minimum level of liquidity is required for the auction process to work efficiently, then why not calculate and mandate a minimum number of real certificates that must held in a exchange reserve system for any company that wants to issue equity to trade on the open market? The reserve certificate count could then be included in the total shares outstanding count, and provide an excellent standalone metric for investors to use in determining the rapid increase or decrease in demand for a particular security. It would also address the issues with trying to calculate an instantaneous short interest. These reserves would be available to the market makers to provide the necessary liquidity in the system when buying demand occurs.

As a final note, in a purely supply and demand context, creation of shares skews the supply, but there appears to be no reciprocal process that allows the increase of demand when there is excessing selling. If the process was truly reciprocal, it would require virtual demand creation and virtual destruction of certificates when there are no short positions to close. Once again this shows an inherent imbalance in the practice of short selling. While credit can be used to create this virtual demand, the dollars extended for that credit are not considered fake like the certificates that are issued to the original owner in a short sale.

Issues With Margin Accounts

Margin accounts are useful in providing investors with an easy credit source that helps smooth the flow of transactions. However, with most agreements for margin accounts, account owners are forced to accept the use of any shares in the accounts for short sales within the brokerage.

A margin account is a service provided for a price. Credit is extended for purchasing assets when the funding is not immediately available. For this service, a margin account holder is charged a interest rate on the money lent until the full purchase price is covered with cash. The margin account construct should be independent from the action of short selling and should allow account holders the right to treat it as such; however, as is current happening other investors are allowed to use the shares you buy to initiate short sales which make money while driving down the share price. For this service, the margin account shows the same amount of shares, with no indication a transaction has occurred. In addition to a fake stock certificate that has reduced in value, no fee was provided to the account holder for the use of their shares. This again is an example of an unfair imbalance caused by short selling that can allow tallying of gains using borrowed property while destroying the value of borrowed property. Most first time investors are not even aware that this happens with a margin account, until a highly anticipated proxy vote is never delivered and they call their broker to find out why.

The main issue stemming from the discussion above can be reduced to the simple fact that everyone expects that when property is borrowed, it will be returned in the same condition with original value or will be compensated for the difference in value. Beyond this basic right, an asset owner can can accept devaluation as a risk, but this should be independent from the margin account construct. Any acceptance of devaluation as a risk demands that a premium be paid to the account holders for the use of their assets. If the borrowing of shares is allowed to continue, the practice should be treated as any other loan and interest should be charged on the borrower and provided to the lender. Allow margin account holders to benefit the same way that cash account holders can by negotiating the compensation for the use of assets within the account. This is only fair since the margin account holders are already being charge for the additional service the account provides.

Thoughts on Liquidity and Efficient Pricing

A supply and demand argument is usually brought up to try and justify the variance introduced by short selling. Specifically, that a skew in supply will be reduced once the short position is closed. Additionally, studies are referenced that try to prove that short selling produces better markets since it provides liquidity and efficient pricing. Even the proposed Uptick Rule release states that this is the commission's general view. From page nine of the release (9):

> *"The Commission has long held the view that short selling provides the market with important benefits, including market liquidity and pricing efficiency. Market liquidity is often provided through short selling by market professionals, such as market makers (including specialists) and block positioners, who offset temporary imbalances in the buying and selling interest for securities. Short sales effected in the market add to the selling interest of stock available to purchasers and reduce the risk that the price paid by investors is artificially high because of a temporary imbalance between buying and selling interest. Short sellers covering their sales also may add to the buying interest of stock available to sellers."*

This is a weak argument to say the least. Short selling cannot offset temporary imbalances when by it's very nature it causes an imbalance. Of course deciding if short selling is an imbalance is dependent on the model used when performing analysis. As presented earlier, there are at least two models where short selling can be seen as an imbalance. So the real questions is, are there no other ways to ensure that the price paid is not artificially high, while not allowing the artificial devaluation of the asset? It seems rather illogical that the market must artificially devalue an asset for the market to function. Following this in the release the commission states:

"Short selling also can contribute to the pricing efficiency of the equities markets. When a short seller speculates or hedges against a downward movement in a security, his transaction is a mirror image of the person who purchases the security in anticipation that the security's price will rise or to hedge against such an increase. Both the purchaser and the short seller hope to profit, or hedge against loss, by buying the security at one price and selling at a higher price. The strategies primarily differ in the sequence of transactions. Market participants who believe a stock is overvalued may engage in short sales in an attempt to profit from a perceived divergence of prices from true economic values. Such short sellers add to stock pricing efficiency because their transactions inform the market of their evaluation of future stock price performance. This evaluation is reflected in the resulting market price of the security."

This would be true if the buyer was aware that they were going to receive borrowed assets. Since a majority of private investors purchasing stock have no insight to the type of stock they are buying the transaction cannot be considered a mirror image. A mirror image transaction only works if both parties are trading real securities without one side of the transaction modifying the underlying value of the asset. In the case of short selling, it creates the appearance of more certificates than are available so therefore the short seller has an advantage over the buyer. The last two sentences of this section are absurd since there must be better ways of informing the market of a seller's evaluation of future stock price performance without directly devaluing the asset. Continuing on page ten (10):

"We recognize that, to the extent that the proposed short sale price test restrictions would result in increased costs to short selling in equity securities, it may lessen some of the benefits of legitimate short selling. Such a reduction may lead to a decrease in market efficiency and price discovery, less protection against upward stock price manipulations, a less efficient allocation of capital, an increase in trading costs, and a decrease in liquidity. Thus, we believe there may be potential costs associated with the proposed short sale price tests in terms of potential impact of such price tests on quote depths, spread widths, and market liquidity. We also believe costs may be incurred in terms of execution and pricing inefficiencies. For example, requiring all short sale orders to be executed or displayed above the best bid, or last sale price, in a declining market may slow the speed of executions and impose additional costs on market participants, including buyers. Also, by not allowing short sellers to sell at the bid, or last sale price, the proposed short sale price tests may impede trading and distort market pricing. "

It is amazing that the sense of fairness in the market for the private investor has been lost in this statement to an overwhelming concern for increasing costs for short selling securities. A short sale can be used to cause a fake acceleration in selling to appear in the market. The reciprocal buying acceleration to close the position can be limited to produce a total net loss in price. Obviously, the opposite argument is made by short sellers for the reverse of this acceleration manipulation on the long side transaction; however, this argument even as presented in the statements above are illogical since long transactions only deal with real certificates and real currency to begin with and the demand, however manipulative, is real. The only thing buyers of securities need is the protection already provided by the rules against manipulation, and the enforcement of those rules.

Options Market Impacts

Some arguments state that stopping the practice of short selling would do little to the current price action and volatility in the market since investors could still obtain short side exposure using put options, or other option strategies. If it would do little to the system then the question is again why do we need short selling at all. Any investor that wants to bet that a stock will decrease in value can use option contracts to provide the same exposure that it is claimed shorting provides, but with the benefit that it does not change the apparent amount of stock certificates for a company. It maintains the supply and demand for the certificates of a company, while providing access to risk that certain investors are willing to pay a premium for. One caveat to the options market in the absence of short selling is that execution of options at expiration must abide by the three business day delivery rules the same as other stock transactions, and any options contracts should never be allowed to result in a net short position when exercised.

Failure To Deliver

Another point of discussion is how to ensure that the failure to deliver of stock certificates carries a penalty that removes any incentives for allowing it to occur. Probably the fairest way is charging a percentage based on the closing stock price per day along with the total number of shares for every day the certificates are not delivered. This interest would be calculated on a daily basis and provided to the buyer when the certificates are finally delivered, as a late fee. A piece of this cost could also be used to fund oversight activities as well.

Conclusion

In conclusion, I have tried to simplify the issues of our complex markets. Sometimes reducing to a single premise and expanding from it is the easiest way to gain basic truths. In this case the single premise is that short selling in any form is a destructive influence, serves no real purpose in the market and does in fact harm orderly markets. In my opinion, short selling breaks what is an otherwise functional system. We are a nation of entrepreneurs, and should be able to work within the bounds of what is morally, socially and legally right. While I understand that issuing an official ruling banning short selling is not an easy task, due to current outstanding short positions and long standing infrastructure, it is something that should be considered honestly and openly, and not clouded by irrelevant issues. Additionally it should be the concern of the commission to provide protection for companies, and thereby shareholders, to prevent the devaluation of their “currency” (or shareholder's property) when destructive influences are allowed and favored.