April 4, 2009

THERE were rumblings last week in the US about possibly reintroducing the uptick rule to short selling.

What's that? The rule, introduced in about 1933 and abolished by the Securities & Exchange Commission with staggering lack of foresight in 2007, states that if you are short selling, you can only initiate the sale at a higher price than the previous sale.

The original intention was to prevent bear raids, in which a gang of financial malconents sell the proverbial out of a stock, without owning it, safe in the knowledge that when they buy the stock back to settle they'll get it for a cheaper price.

Barney Frank, chairman of the US House of Representatives' Financial Services Committee, said last Monday that he hoped the SEC would shortly reinstate the uptick rule, possibly within a month.

So what's happening in Australia? Do we have one and do we need one? Glad you asked. It's still on the books of the ASX Listing Rules, but it hasn't been used since ASIC banned naked short selling late last year, and there's been the erroneous impression around that the uptick rule took the dive with the imposition of the ban on naked short selling.

This is where we're glad we're not Senator Nick Sherry, who is wrestling with the job of devising a set of regulations to allow full implementation of the Corporations Amendment (Short Selling) Act of 2008 that he brought in late last year. Because here's the crunch. That amendment was brought in to clarify what a short sale actually was, since a lot of traders who had been borrowing stock to cover short sales hadn't been reporting the sales as being short.

The amendments went through, so now a covered short sale is officially a short sale. In that case there could and should be a debate about reintroducing the uptick rule, a la SEC, as a possible way to get short selling happening again in financial stocks in Australia without the sky threatening to fall in. It's still illegal to short financial stocks here, even covered, although there are various ways to get round the ban.

That's the headache: most people agree that short selling is a necessary part of trading, but they're also aware that organised smarties can do (and have done) horrible things to the prices of bear raided companies. The uptick rule, like the Glass-Steagall Act, was brought in in the 1930s for a reason and although many things in life have moved on, the original justification for the legislation has never actually gone away.

There's also another complication for Senator Sherry. Back in the 1930s, there wasn't a significant trade in over-the-counter derivatives, but there is now. It's now possible for a bank to issue derivatives that cause it to have to short stock as a hedge, in which case there would need to be a carve-out of any uptick rule for them because the only targets of an uptick rule should be rogue short sellers rather than hedgers. The hedgers aren't actually trying to force prices down.

The same should also apply to index arbitrageurs, whose stock in trade is to buy and sell blocks of stock against blocks of index futures, on the short and long side. They weren't around in the 1930s either. They've been sitting on the sidelines lately because they aren't allowed to short financials and also because index arbitrage requires them to borrow lots of money, which in many cases they can't at the moment.

But sooner or later they will be back, for two reasons. One, they can make money, and two, because index arbitrage helps smooth the difference between index futures and physical stock indices, which is good for markets. They too should get an exemption from any reimposition of the uptick rule because, again, they're not trying to push prices down.

The Australian Shareholders Association wants to see the uptick rule retained and operated, as does commentator John Green, a recovering Sydney takeover lawyer who was sharp enough to point out late last year that there was nothing about uptick in the legislation that Sherry brought in.

Others aren't so sure it's necessary. Corporate government consultant Dean Paatsch points out that it's very easy to put through a small trade at an artificial price before initiating a short sale, thus getting round the rules. Chris Gosselin, chief executive of Australian Fund Monitors and the man who often finds himself defending hedge funds even though he isn't one, says the uptick rule will be "incredibly difficult to police or to implement, and for that reason I don't think it's very effective". He says an alternative might be for the ASX to put restrictions on short selling in specific stocks at specific times "depending on outstanding short positions or underlying volatility".

A spokesman for Senator Sherry said on Friday that "the Government is developing regulations on the disclosure of covered short selling. We are aware of debate around the uptick rule, among many other regulatory issues on short selling. ASIC is engaged internationally in the IOSCO working group on short selling and the Government is monitoring these developments." (IOSCO is the

International Organisation of Securities Commissions, which aims to standardise market rules where possible.)

"Under the expanded short selling powers given to ASIC last year, it now has the power to impose the uptick rule on covered short sale transactions if it considers this appropriate -- for example, in extreme market conditions," the spokesman said.

And that's the point. We're not sweating over normal market conditions but over circumstances where a company's share price can drop between 20 and 30 per cent in a day. The uptick rule may not be the perfect solution, but with the biggest share market in the world looking seriously at bringing it back in, we'd be remiss not to look at the issue in a clear-eyed way. The cynics might say that one sure way to get the markets to move up is to set up clear rules for short sellers, who want to move it down, but that would be the least of our worries if it turned out that way.

From: Lou Walls

To: chairmanoffice@sec.gov; enforcement@sec.gov; rule-comments@sec.gov; newyork@sec.gov; philadelphia@sec.gov; chicago@sec.gov; losangeles@sec.gov; boston@sec.gov; oca@sec.gov
Sent: Saturday, April 4, 2009 12:02:20 AM
Subject: Re: Please read and forward to responsible department. Thank you

here's one more reason...please take the time to read. u will be better informed. thank you.

In July 2007 the Securities and Exchange Commission suspended the uptick rule after years of pressure from the hedge fund community. Created in 1938 as a response to the market manipulation that lead to the market crash of 1929, in loose terms it prevents a firm from selling a stock short unless the price of the stock has “ticked up” from the last trade price. Such an uptick is typically generated by a buyer entering the market. In theory, the rule was designed to prevent short sellers from repeatedly selling shares short in the absence of interested buyers.

Combined with the suspension of the uptick rule was lack of enforcement of naked shorting. In every stock shorting situation, whether the uptick rule is in place, the firm selling the stock short must borrow the shares they sell. The business of borrowing and lending shares has grown to a trillion dollar industry over the past 10 years with billions in profits generated by firms such as Goldman Sachs to JPMorgan Chase. Ironically, it was this business line at AIG that led to tens of billions in losses. What should have been a very conservative short-term investment, they invested the cash collateral of their hedge fund clients into subprime mortgages. Big oops.

Naked shorting occurs when a firm sells a stock short and then is unable to borrow the shares they just sold. Governed by the laws of supply and demand, the market for buying and selling of company shares are limited to the total number of shares the company has issued. But if a trader is able to sell shares without ever owning or borrowing them, the trader has in effect increased the number of company shares. In essence, naked shorters are able to issue their own shares solely for the purpose of driving down the stock price. Combined with the suspension of the uptick rule, this is a lethal combination.

According to one statistic reported by Bloomberg, on the Thursday just prior to Lehman Brother's collapse, 33 million shares of stock were sold as naked shorts. That was equivalent to all the shares of Lehman bought and sold on an average trading day. It was as if an entire group of investors from a parallel universe arrived and sold phantom shares for the entire day. It is no wonder the share price collapsed, irrespective of the underlying economics of the firm. Ultimately, the failure of Lehman lead to a far greater economic crisis as the financial system froze.

These are just two of many conditions that opened the financial markets to manipulation. From the undercapitalization of Fannie Mae to the unregulated market for Credit Default Swaps, we created an environment in which the financial markets could take control of our economic health. The motivation behind these actions has been the same for most of humanity — personal gain. Whether it is AIG bonuses, hedge fund's destructive trading strategies or political myopia, we've allowed our ambitions and me-first culture to derail the system that feeds us all.

This is not a doom-and-gloom story, however. While the economy was headed towards weakness, it was driven to this extreme by factors that can be fixed. The system is not broken, and there are many good people working day and night to repair the economy, from these same politicians to the millions of small business owners. The perspective check, however, is one of grounding. While we are emotionally vulnerable to the exuberance of profits, we have fallen into the dark abyss of fear and panic. Neither extreme is grounded in reality, and just as market bubbles fizzle, so won't our bubble of fear.

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To: chairmanoffice@sec.gov; enforcement@sec.gov; rule-comments@sec.gov; newyork@sec.gov; philadelphia@sec.gov; chicago@sec.gov; losangeles@sec.gov; boston@sec.gov; oca@sec.gov
Sent: Friday, April 3, 2009 3:40:37 PM
Subject: Please read and forward to responsible department. Thank you

Good day madam/sir, please forward these comments to responsible party including Chairman Mary Schapiro.

This has been on several major blogs and most of us agree with its comments.

– Exchanges Propose Fake Uptick Rule –

Lawmakers from both parties are pushing for the reinstatement of the uptick rule. In a letter to SEC, US Exchanges NYSE, Nasdaq and others proposed last week what they call “Modified Uptick Rule”. Their proposal is a sham.

This is what they propose (see the link below for the original letter): No rule is needed in a normal market. If a stock drops by 10%, a Circuit Breaker will trigger after which short selling will be controlled for the rest of the day. In the controlled environment (after the 10% drop!), shorting will be allowed only at a price above the highest prevailing national bid.

This is ludicrous. This is NOT uptick rule. It is Fake Uptick Rule. Frankly, it is an insult to all lawmakers seeking the reinstatement of the real uptick rule. I ask to CEOs of NYSE and Nasdaq – Who are you trying to fool? Why are you in bed with the short sellers?

The letter by the CEOs of the Exchanges is full of lies. They claim “This modified uptick rule is superior to the original uptick rule in several ways.” Oh, ya? The real uptick rule worked well for 70 years preventing mischiefs by shorts. You did not have to wait for the stock to go down 10%. It is like banks saying that they will turn on their security systems after some thieves rob 10% of their assets. What a joke! Our stock exchanges are now run by people who dance to the tune of powerful hedge funds from Greenwich, New York and elsewhere (Look for the ten largest hedge fund families and you will know who is really behind this BS).

Exchanges are also lying that it is very hard to implement uptick rule in today’s decimal pricing environment. Decimal prices began on all stocks in April 2001. From April 2001 to July 2007 (when the uptick rule was removed), for six years, the exchanges complied with the uptick rule. Are they saying, computers are less powerful now than they were three years ago? That is baloney! (Actually, in a conference call in October 2008, NYSE CEO Niederauer had said that the uptick rule was easy to understand and was easy to re-implement.)

For NYSE and Nasdaq, this is also a major dereliction of their responsibilities towards their member companies. A poll by NYSE in 2008 said, 85% of its member companies want the uptick rule reinstated. BATS serves traders and short-sellers. So they are fighting to not bring back the rule.

SEC, Congressmen, mutual fund managers, millions of individual investors (who can not even short stocks in their 401Ks) – You have been forewarned. Do not be fooled by lies and the fake uptick rule proposed by major exchanges. Please bring back the real uptick rule promptly! I hope that SEC does so but if they do not, it is time for Congress to act.

Exchanges' letter

http://online.wsj.com/public/resources/documents/ExchangeShortSaleLetter0324.pdf

Thank you for your time,

Luis Paredes