

June 19, 2009

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

Re: Amendments to Regulation SHO (File No. S7-08-09)

Dear Ms. Murphy:

Short selling has existed for 400 years¹. Blaming short selling for price declines has existed for 400 years. Attempts to eliminate or curb short selling in order to curtail price declines have been going on for 400 years. Inevitably, recognition of the foolishness of blaming short selling for price declines has eventually prevailed^{2,3,4}. All of this has happened before, and all of this will happen again⁵.

The SEC's 2004-2007 pilot study was a sharp break from history. It was a massive attempt to *scientifically measure* the *actual effects* of short selling restrictions in the real world with a very large control group for which all other variables should either be the same (i.e. macroeconomic conditions) or randomly different (i.e. issuer specific news). In addition to the Office of Economic Analysis's own study⁶, four independent research studies specifically examined the pilot data.⁷ The specifics of these studies have

¹ See for example van Dillen, J. (1927), 'Termijnhandel te Amsterdam in de 16de en 17de eeuw', *De Economist*: 503-23., van Dillen, J. (1930), 'Isaac Le Maire en de handel in actien der Oost-Indische Compagnie', *Economisch-Historisch Jaarboek*: 1-165, van Dillen, J. (1935), 'Isaac le Maire et le commerce des actions de la Compaigne de Indes Orientales', *Revue d'Histoire Moderne*: 5-21, 121-37

² See Meeker, James Edward. Short Selling. Harper & Brothers, 1932 for examples such as Holland(1610), Great Britain(1733 "Sir John Barnard's Act"), Great Britain(1866 "Leeman's Act") France(1802 Napoleon I), France(1914), France(1931), Germany(1896), New York State(1812), USA (1864 law pertaining to gold... repealed 2 weeks later)

³ See also for example Yidi, Zhao and Zhang Shidong. "China Allows Short Sales, Margin Loans to Help Market" Bloomberg News Sept 26,2008

<<http://www.bloomberg.com/apps/news?pid=20601087&sid=ajvJdZpdH3LQ&refer=home>> for description of China's decision to allow short selling for the first time in September of 2008 in order to stabilize the market

⁴ See also for example Sharif, Farhan. "Pakistani Investors Stone Exchange as Stocks Plunge" Bloomberg News July 17, 2008

<<http://www.bloomberg.com/apps/news?pid=20601080&sid=aO4E38y0bggho&refer=asia>> for description of Pakistan's emergency decision to lift its "ban on short selling... after volumes fell to the lowest in a decade." In July of 2008

⁵ See "Battlestar Galactica" (2004-2009)

⁶ Per the SEC release the "OEA found little empirical justification at that time for maintaining short sale price test restrictions, especially for actively traded securities."

⁷ See Karl B. Diether, Kuan Hui Lee and Ingrid M. Werner, 2009, It's SHO Time! Short-Sale Price-Tests and Market Quality, *Journal of Finance* 64:37-73; Gordon J. Alexander and Mark A. Peterson, 2008, The Effect of Price Tests on Trader Behavior and Market Quality: An Analysis of Reg. SHO, *Journal of Financial Markets* 11:84-111; J. Julie Wu, Uptick Rule, short selling and price efficiency, August 14, 2006; Lynn Bai, 2008, The Uptick Rule of Short Sale Regulation – Can it Alleviate Downward Price Pressure from Negative Earnings Shocks? *Rutgers Business Law Journal* 5:1-63 ("Bai").

been rehashed elsewhere, but to quote the SEC's release, "Generally, the Pilot Results supported removal of short sale price test restrictions at that time." The Commission subsequently proposed removing short sale price restrictions altogether and opened the proposal up for comment. "The Commission received 27 comment letters in response to its proposal to eliminate former Rule 10a-1 and prohibit any SRO from having a short sale price test... Two commenters (both individual investors) opposed the proposed amendments noting the need for price tests to prevent 'bear raids.'"

One of those commenters was David Patch, paid lobbyist of overstock.com CEO Patrick Byrne. Overstock.com is a failed leftover of the dotcom bubble that has had negative earnings for at least the last seven consecutive years. I highly recommend buying consumer items on overstock.com Their prices are unbeatable. So unbeatable in fact that they lose money every year. Patrick Byrne however is on a one man mission to convince the world that his company is failing because people are shorting his stock. He once publicly blamed the 'Sith Lord' for naked shorting his stock.⁸ This is entirely unbelievable because a Sith Lord could just use the force to cause the stock price to decline⁹.(With little risk of detection by the SEC)

Bear Raids, are, of course, a real problem¹⁰¹¹¹² However there is little evidence of Bear Raids in the financial markets causing recent downturns in stocks. Page 10 of the SEC release states, "Although short selling serves useful market purposes, it also may be used to illegally manipulate stock prices," and footnotes two examples. US v Russo and SEC v Gardiner. However, these examples are in no way implicative of short-selling as a manipulation-prone tool. In US v Russo, short selling was only used to take advantage of a bug in the clearing firm's margin calculations in the fall of 1986 to maintain enough liquidity to support the rest of the alleged criminal behavior¹³. In SEC v Gardiner, short

⁸ See Nocera, Joe. "Overstock's Campaign Of Menace" New York Times Feb 25, 2006

⁹ See "Sith Lord" on Wookieepedia, the Star Wars Wiki <http://starwars.wikia.com/wiki/Sith_Lord>

¹⁰ See "Bears Raid Trash" on youtube <<http://www.youtube.com/watch?v=PLMh7O5pJk0>>

¹¹ See "Bear attacks prove deadly for 2" Aug 17, 1996 Deseret News

¹² Yogi bear was also known to raid picnic baskets. See for example Mallory, Michael. *Hanna-Barbera Cartoons*. New York: Hugh Lauter Levin Associates, 1998

¹³ See US v Russo <<http://www.altlaw.org/v1/cases/551897>>

A brief recap: Russo bought Kureen & Cooper brokers, who specialized in penny stock IPOs, in 1985 after his previous firm went out of business due to insufficient minimum capital. In August of 1986, K&C found themselves running into netcap and cashflow problems because they were long lots of stock and warrants in two IPOs that went bad (Lopat and EAS). From August to October of 1986 K&C manipulated Lopat and EAS stock to prevent them from falling by:

- 1) making unauthorized purchases in customer accounts
- 2) if/when the customer complained after receiving the confirmation, K&C would tell them that a mistake had been made, stall by seeking a 7 day credit extension, then either buy back the stock or cancel the trade, then frequently take the same block of stock and place it in another customer account without authorization
- 3) K&C also parked stock in customer accounts by agreeing to buy back the stock from the customer in one or two weeks an eighth or a sixteenth higher. K&C would often immediately park the same stock with a new customer

At the same time, K&C discovered a bug at their clearing firm (Evans and Co) wherein they could incorrectly place short sales in their regular cash account rather than their margin account, and the clearing firm would immediately credit the entire notional of the trade as cash. K&C exploited this bug by short selling unrelated stocks to generate cashflow to continue propping up Lopat and EAS stock.

selling in August of 1986 *is* implicated in manipulating prices in smallcap stocks; however the short selling in question is only a small part of the systematic violation of rules and manipulative practices used here... including using buying to manipulate prices upward. Thus this example of fraudulent behavior implicates the act of short selling stock no more so than it implicates the act of buying stock. (See endnote¹).

This evidence hardly stacks up to the rigorous scientific discovery process which led to the elimination of price restrictions on short selling in the first place.

As additional evidence the SEC states on page 20 of the release “Researchers have also indicated that they believe that they have collected data that establishes a possible association between the current market downturn and the elimination of former Rule 10a-1.” The citation is ‘Technical Report on the SEC Uptick Repeal Pilot’ a ‘report’ by a physicist consisting of 2 pages of text (and an op-ed by the same author)¹⁴. That report basically argues that using a z-test there are significantly more one day declines in stock prices after the repeal of the uptick rule than before it. The report states as an axiom that “These sharp declines serve as a proxy for bear raids.” This statement simply is not supported by evidence. The authors argue that “the uptick rule repeal as a major contributor to, if not the outright cause of, the current severe financial crisis.” This is a clear fallacy of post hoc ergo propter hoc. It can be shown with a much higher statistical significance that there are more cases of swine flu after the repeal of the uptick rule than prior to it¹⁵. There is therefore equal evidence that repealing the uptick rule caused the swine flu pandemic. Additionally the z-test relies on the assumption that the underlying data is normally distributed, but stock price movements are NOT normally distributed¹⁶.

Additionally many have pointed to a chart and argued that because stock prices dropped precipitously after the repeal of the uptick rule, repealing the uptick rule caused prices to rapidly decline. But as the following chart shows, the Dow Jones Industrial

The combination of all these rule violations and dishonesty allowed K&C to delay the inevitable closing of the firm due to insufficient capital until December 1986, when the clearing firm terminated the clearing agreement. Russo and his brokers opened a ‘new’ securities firm in the same office less than two weeks later.

Russo and his brokers clearly behaved unethically, dishonestly, and broke numerous rules. It is tenuous however to describe their behavior as ‘short selling... may be used to illegally manipulate stock prices.’ The stock prices of Lopat and EAS were manipulated by falsifying customer order tickets, placing ‘customer’ buy orders without permission, lying and delaying if the customer complained, illegal profit guarantees and prearranged buybacks, trades done off exchange and outside the NBBO. These manipulations were done to *prevent* the stocks in question from falling (antithetical to the motivation behind the proposed uptick rules). The short selling in question (in unrelated stocks) *indirectly* facilitated the price manipulations to the extent that by mismarking the trades, and abusing and exploiting the bug in their clearing firm, they were able to prevent their impending bankruptcy by manipulating their cash flow, and said bankruptcy would prevent their continued manipulations of the stocks in question. It is also worth noting that while the perpetrators clearly had no qualms about breaking the rules, it is not clear that they would have broken any of the currently proposed new rules.

¹⁴ Harmon, Dion and Yaneer Bar-Yam. “Technical Report on SEC Uptick Repeal Pilot” November 2008 <<http://www.necsi.edu/research/UptickTechReport.pdf>>

¹⁵ Earliest swine flu cases were March of 2009, See for example "Outbreak of Swine-Origin Influenza A (H1N1) Virus Infection --- Mexico, March--April 2009". *Morbidity and Mortality (Dispatch)*. Centers for Disease Control. 2009-04-30

¹⁶ See Taleb , Nassim Nicholas. “ The Black Swan: The Impact of the Highly Improbable” (April 2007)

Average dropped extremely rapidly in the two months following the original implementation of the uptick rule on Feb 8, 1938¹⁷:



Additionally, the Dow fell 20% from Sept 19, 2008 to Oct 8, 2008 while the SEC's emergency short sale ban was in effect.

In short, not only are the assumptions baked into the current proposed rule unsupported, but in fact the preponderance of evidence contradicts the theory that short sale price restrictions protect the market from rapid declines. I therefore strongly urge the SEC **not** to reinstate them.

ⁱ SEC v Gardiner from LexisNexis:

SECURITIES AND EXCHANGE COMMISSION v. PETER R.
GARDINER, United States District Court for the Southern District of New
York, Civil Action No. 91 Civ. 2091 (MP) (S.D.N.Y. 1991)

SECURITIES AND EXCHANGE COMMISSION

LITIGATION, Release No. 12818

1991 SEC LEXIS 580

March 27, 1991

TEXT: [*1]

¹⁷ See yahoo finance: <<http://finance.yahoo.com/q?s=^DJI>>

The Securities and Exchange Commission today announced the filing of a civil action for permanent injunctive and other equitable relief in the United States District Court for the Southern District of New York against Peter R. Gardiner ("Gardiner"). Without admitting or denying the allegations of the Complaint, Gardiner consented to the entry of a Final Judgment of Permanent Injunction enjoining him from violating or aiding and abetting violations of antifraud and other provisions of the federal securities laws, including Sections 7(c), 7(f), 8(a), 9(a)(2), 10(b), and 17(a)(1) of the Securities Exchange Acts of 1934 ("Exchange Act") and Rules 10b-5, 10b-6, 17a-3, and 17a-4, and Regulations T and X promulgated thereunder, and Section 17(a) of the Securities Act of 1933.

I. Gardiner's Unlawful Arrangements With Clients

According to the Complaint, from in or about June 1985 to February 1988, Gardiner was employed as a convertible securities trader and at times acted as sales representative in the High Yield and Convertible Bond Department ("HYBD") of the broker-dealer subsidiary of Drexel Burnham Lambert Group Inc. ("Drexel"). In its Complaint, the Commission alleges that [*2] Gardiner at times engaged in manipulative practices at the direction of superiors in the HYBD, by directing or inducing security trades in the accounts of certain customers. The Commission further alleges that by engaging in these practices, whereby Drexel retained an undisclosed beneficial interest in the traded securities, Gardiner aided and abetted Drexel's and certain customers' violations of various antifraud, antimanipulation, margin, and books and records provisions of the federal securities laws.

According to the Complaint, the manipulations were usually associated with the offering of convertible securities and they had several different purposes depending on the circumstances that existed at the time of the offering. In certain situations where there was excessive or insufficient demand for the offered convertible securities, Gardiner "parked" part of the offering in customer accounts in order to enable Drexel to reclaim the parked securities from these nominee accounts and to sell them to the public at a price greater than the price Drexel would have received had it sold the securities in the offering to bona fide purchasers.

In addition to "parking" part of some [*3] convertible bond offerings, the Commission alleges that it was often a further part of the manipulative practice for Gardiner to direct or induce customers to sell, in what is termed a "short sale," a corresponding quantity of borrowed shares of the associated common stock before the offered convertible securities were priced in order to depress the price of the common stock. In its Complaint, the Commission specifically alleges that in August 1986 the securities of Sterling Software Inc. were among the securities manipulated in this fashion.

In addition to the manipulative practices that Gardiner engaged in relating to the offering of convertible securities, the Complaint further alleges that on at least one occasion he participated in the direct manipulation of the price of a common stock. The Complaint alleges that prior to a secondary offering of the common stock of BRIntec Corporation ("Brintec") that was being underwritten in part by Drexel in or about April 1986, Gardiner was instructed by one or more of his superiors in the HYBD to direct and induce his customers to purchase Brintec common stock on Drexel's behalf in order to increase its price. Among the selling shareholders [*4] in the secondary offering was a partnership composed at the time of an officer and then present and former employees of the HYBD. According to the Complaint, the active trading induced by Drexel and Gardiner artificially raised the price of the stock and resulted in a higher price for purchasers and sellers of the secondary offering of shares, including the Drexel employee partnership.

II. Proposed Administrative Proceedings

As part of the settlement, upon entry of the Final Judgment, the Commission will institute administrative proceedings against Gardiner pursuant to Section 15(b)(6) of the Exchange Act. Simultaneously with the institution of those proceedings, Gardiner will consent to the issuance of a Commission Order barring Gardiner from association with any broker, dealer, investment adviser, investment company, or municipal securities dealer, with the provision that, after three years from the date

of the Order, he may apply to the appropriate self-regulatory organization, or where there is no appropriate self-regulatory organization, to the Commission, to become associated in the above capacities.
