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Since 1934

# Security Traders Association

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May 4, 2009

The Honorable Mary L. Schapiro  
Chairman  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549

**SUBJECT: File Number S7-08-09**

Dear Commissioner Schapiro:

The Security Traders Association (STA) has been involved in the short sale discussions for decades. We have long respected short sales as a valid investment alternative. We have held equally strong support for strict enforcement of locate and delivery rules that serve to eliminate illegal and abusive short selling, including naked shorts.

The current discussions on how to combat abusive short selling and the attributed volatility have been trading centric (trading triggers result in trading restrictions). We believe that the past 18 months have taught us that we need to think outside the box. The STA has communicated our concerns about "tick tests" and "bid tests" on many occasions in the past. We believe that price tests (such as the "bid test" or "tick test") have been rendered ineffective by structural changes to the markets and that price tests would be unable to dampen volatility even if they were to be reinstated.<sup>1</sup> It is the considered position of the Board of Directors of the STA that an objective means of establishing benchmarks for these tests does not exist in today's market structure. We continue to believe that both tests are seriously flawed and if they were to be implemented gaming of these types of trading restrictions would become rampant again. Neither price test would present any appreciable resistance for abusive short selling in downward spiraling issues and thus would be ineffective in solving the current quandary. The STA believes that rules should be promulgated to control identifiable and measurable problems, and does not believe that reincarnating discredited regulations of yesteryear will position us to effectively compete in today's markets. In this vain the **Security Traders Association has developed an alternative Short Sale Circuit-Breaker Proposal.**

<sup>1</sup> Special Report: The STA's Perspective on U.S. Market Structure, May 2008, p. 17.

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*Dictum Meum Pactum*

The equity markets have functioned extremely well during the recent financial meltdown. At times they have been the last frontier of liquidity. When an investor has wanted to trade stocks, the equity market has been there with bids and offers to facilitate their transactions. In the current market structure, where multiple trades occur in sub-second intervals at multiple trading venues, any attempt to slow the trading pace or the momentum of prices is an extremely intricate issue. Indeed, the SEC deemed the fast markets of electronic trading to be the solution to all of the markets' woes and thus strongly encouraged fast markets while promulgating Regulation NMS.

Furthermore, the limited nature of the alleged problem, abusive short selling, argues against imposition of trading restrictions market-wide. Bid and tick tests would require all market participants to retool their systems at significant expense. However, the alleged activity that these regulations are attempting to curtail are allegedly undertaken by an extremely small group of well-funded market participants bent on exploiting perceived loopholes in the rules for their own pecuniary interests. A recent study of trading data by Deutsche Bank shows that "as stocks plunged in September (2008), fewer than 8 percent of trades for companies in the S&P 500 Financials Index were done on consecutive downticks."<sup>2</sup> Another recent study of exchange data by Bloomberg reveals, "When Citigroup plunged 26 percent on Nov. 20, (2008) the steepest drop on record for the New York-based bank, downticks represented 7.1 percent of trades."<sup>3</sup> The STA believes that market-wide trading restrictions aimed at curbing less than 10 percent of trading activity represent burdensome regulations and an unnecessary interference with price discovery mechanisms that, for the most part, are functioning with historical efficiency, especially when other rules and regulations already on the books could be used to curtail this perceived problem (e.g. Rule 203T and strict locate requirements).

The STA seriously questions the workability, enforceability and effectiveness of the proposed tick test. Active stocks currently witness hundreds of trade executions every minute on over fifty different venues. These trading venues are decentralized and some are a great distance from the securities information processor (SIP). The distance that messages travel to the SIP causes delays in the SIP receiving the message. Thus messages are not always received in the order that they were traded. Also, trading centers are required to publish trades within ninety seconds of the actual execution, an enormous amount of time in fast markets. This creates further confusion in the correct order of trades and thus the proper legal tick upon which to benchmark a short sale. Even without these problems, identifying which of the hundreds of ticks occurring while a short sale is being executed is a very subjective task that presents difficulties for those trying to comply and creates opportunity for those wishing to evade. The SEC will have a monumental task deciphering which is which.

Ignoring the problems presented by the uptick proposal, let's examine how effective such a regulation could be in the current markets. Placing an uptick requirement of one or two cents on a short sale will only require that the order wait a millisecond for execution. Prices literally fly between bid and ask as orders taking liquidity reach the markets and execute. Furthermore, forcing a short to post a short sale as an offering is very little deterrent for those wishing to "press their bets." To avoid the tick/bid test regulations, all the short seller would need to do is rewrite their computer programs so they would always be one tick level above the last sale. This type of strategy can be detrimental to the markets because it gives the constant appearance of a ready supply of stock for sale. Alternately, short sellers could be driven to create a "tick haven" in dark pools where they could offer their short shares at spread midpoints

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<sup>2</sup> Edgar Ortega & Jesse Westbrook, "Uptick Rule May Fail to Lift Stocks, Curb Volatility," [Bloomberg News](#), December 9, 2008.

<sup>3</sup> *Ibid.*, [Bloomberg News](#), December 9, 2008.

for executions. This would drive significant volumes to non-public markets thereby reducing market transparency and liquidity. As the tick interval is moved past three cents it quickly approaches a short sale ban, which is clearly not the intent of this type of regulation.

Bid tests reminiscent of the old NASDAQ bid test (NASD Rule 3350) also concern us for many of the reasons set forth above. Flickering quotes and fifty-plus venues constantly updating their markets aside, these tests have always been ripe for gaming. In the current market environment where participants can purchase different types and speeds of market data feeds (which are purchased at markedly different prices), some of which display quotes several seconds faster than others, which data feed speed will set the bid benchmark? Further it costs manipulators very little to place a small bid to create an up-bid scenario. Many electronic orders and algorithmic strategies that investors, large and small, use to access the markets are programmed to peg their buy interest to the best bid. The very retail investor orders that this rule is being fashioned to protect will follow the manipulated bid, moving their bids up like lemmings led to (an) execution by the manipulators own larger short orders. Is this the protection that we want to hold out to investors in an attempt to restore confidence?

Bid and tick tests create an uncertainty as to whether a short sale can be consummated and thus uncertainty as to whether complete trading strategies can be implemented. In many cases, this uncertainty will persuade the participant considering implementation of that strategy to forgo the potential trade resulting in lost liquidity and wider price spreads. Many of these trades are hedged strategies where not only the short sale is forgone, but the simultaneous purchase of other securities is also abandoned. "The STA believes that regulatory intervention in the markets should not be done in such a way as to inhibit competitive market forces and practices, which otherwise would have determined prices."<sup>4</sup>

The SEC recognized the flaws that had rendered the price test rules obsolete and proactively attempted to formulate rules that could effectively prevent abusive short selling. Regulation SHO was the result of those efforts. Recognizing that focusing on price constraints or even trading constraints in a one-hundred price point sub-second trading environment would be futile, the Commission concentrated on how to efficiently constrain short selling on the issuer and back-office side of the equation while removing the ineffective price tests.<sup>5</sup>

It is our view that the most effective remedy to the current situation is rigorous enforcement of existing laws, rules, and regulations. The current regulatory regime, properly enforced, is sufficient. We believe that additional regulation is neither necessary nor would it be helpful. In particular, the STA has long supported the strong enforcement of the (stock) locate and delivery rules designed to prevent abusive or illegal short selling. The STA has previously questioned the appropriateness of certain interpretations of the locate rules and would respectfully suggest that these interpretations are a probable cause for the same piece of stock being used for multiple locates. Further, we support the strong enforcement of regulation and law aimed at those who engage in market manipulation through the dissemination of rumors, collusive schemes, or other conduct intended to manipulate securities prices.<sup>6</sup>

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<sup>4</sup> STA Comments on Emergency Action by SEC Comment Letter, July 23, 2008, p. 2, <[http://www.securitytraders.org/file\\_download/149](http://www.securitytraders.org/file_download/149)>.

<sup>5</sup> Special Report: The STA's Perspective on U.S. Market Structure, May 2008, p. 18.

<sup>6</sup> STA Comments on Emergency Action by SEC Comment Letter, July 23, 2008, p. 2, <[http://www.securitytraders.org/file\\_download/149](http://www.securitytraders.org/file_download/149)>.

One only need compare the Regulation SHO threshold lists from July 2008 and today to see the effectiveness of strict enforcement of settlement rules. In July these lists contained over 500 names, yet today there are 70 names on the list and only three of those are NYSE or NASDAQ listed issues. This remarkable step in combating abusive short selling is the direct result of strict enforcement of rule 203T. However, the problem still persists. While the *New York Times* was reporting these very successes, it stated at the beginning of the article “Naked short-selling... is illegal if it is intended to manipulate the market.”<sup>7</sup> SEC needs to clearly and unambiguously communicate to all market participants that naked short selling is illegal, and any transgressions will be prosecuted to the fullest extent of the law. This industry can promulgate rules and regulations until we are blue in the face, but without an unambiguous definition of naked short selling and a clear pronouncement that it is illegal from the regulators, this problem will persist.

The Security Traders Association holds firm that if the regulations currently on the books were strictly enforced, they would be sufficient to eliminate the problems of abusive short selling. We also believe that it is best to allow a new regulation time to demonstrate its effectiveness prior to promulgating new regulations. If, however, the Commission intends to promulgate new regulations at this time, we believe that we have developed a trading circuit-breaker concept that will enhance the current regulatory regimen and slow potentially abusive short selling, without creating the problems associated with the bid and tick tests.

### **The Short Sale Circuit-Breaker Proposal**

The Security Traders Association propose a Circuit-Breaker scenario where once the Circuit Breaker Election Level (X) from the issue’s previous nights close is hit (e.g. 10%), all further short sales must pre-borrow stock. Thus, if stock ABC were to decline X from ABC’s previous close (e.g. 10%) during a trading session, the securities information processor (SIP) would flag the issue as distressed. All shares to be sold short in the distressed issue from the time the SIP flags the issue as distressed until the issue opens in the next day’s regular trading session must be borrowed prior to that short sale being executed. There would be exemptions for bona fide market makers, bona fide options market makers and international or domestic arbitrage scenarios from the mandatory pre-borrow between the previous close and level X+Y (e.g. 20%). Once X+Y (e.g.20%), is reached, the mandatory pre-borrow would apply to all short sales, no exemptions. If the issue were to continue to decline at election level X+Y+Z (e.g.30%), a short sale ban for the remainder of the trading session would be implemented.

This circuit-breaker scenario would apply to individual securities on an issue by issue basis. It would become effective only after an issue reached the circuit-breaker election level and was flagged as distressed by the SIP, thus leaving overall markets to function normally. This proposal would only react when and where the regulation is needed. This proposal also eases enforcement problems as regulators could easily spot the distressed situation flag sent out by the SIP, narrowing their search for possible manipulative behavior and allowing them to concentrate their enforcement energies where potential manipulators may be operating.

Implementing this proposal as a proscriptive rule where the behavior is specifically not allowed would be more appropriate than implementing it as a principles-based rule. Principles-based rules admit defeat in their promulgation. “Since everyone can not comply, we will ask that you have policies and procedures in place to identify and correct exceptions.” While principles-based rules are valuable in the fast-paced

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<sup>7</sup> Floyd Norris, “Goodbye to Naked Shorting,” [The New York Times](#), April 30, 2009.

trading arena, on the back-office side, a much more methodical environment than the trading arena, once the SIP flags an issue as distressed, there would be a mandatory pre-borrow, no ifs, ands, or buts. If the participant cannot borrow the stock, then it would be illegal to execute a short sale.

Compliance would be on the participant side with primary supervision executed by the broker/dealers. The cost of compliance would be borne by exactly the market participants who are earning monies by enabling short sellers to participate in the markets, the most efficient cost allocation possible. The broker/dealers back office would need to have a program in place that would recognize the SIP flag and prevent any customer from executing a short sell without the override of a mandatory pre-borrow.

Implementation of the STA circuit-breaker proposal may have benefits for broker/dealer self regulation as well. For example, if a circuit breaker is triggered, that information may result in the broker/dealer back office increasing margin requirements on that stock security. A tripped circuit breaker will also be an alert for the compliance department of the broker/dealer to insure enforcement of the rules.

The process of entering into an enforceable borrow agreement prior to making any further short sales will provide the desired “timeout” for the distressed issue, giving time for rational participants to evaluate what price the issue should be trading at. This timeout period is actually scalable, as an issue becomes harder to borrow, the process of borrowing shares becomes more onerous and time consuming. There is also a real and significant cost associated with entering into the borrowing agreement on trade date. Normally a short seller would locate shares to borrow on trade date and not enter into the borrowing agreement until settlement. Only when the short seller actually enters into the borrow agreement does he begin to pay for the borrowed shares. Forcing short sellers to enter into these borrow agreements three days earlier than they would normally borrow securities will change the profit/loss relationship of the proposed short sale, compelling less confident short sellers to abandon the trade and find greener pastures elsewhere, while allowing short sellers with conviction in their strategy to enter into the trade at a higher cost. Market participants understand the economics of trading and react quickly to avoid economic hardship; this proposal would literally hit them in the pocketbook. Quick-buck artists would be discouraged as their profits dwindled and other market participants would not even know this was happening. The mandatory pre-borrow would also immediately reduce the pool of shares available to borrow, thus making an issue more difficult to borrow and raising the borrowing costs.

This proposal would address potentially abusive short selling in the after-hours markets. While other proposals require a benchmark for sales to occur, the STA circuit-breaker proposal does not require such a benchmark. Once the circuit breaker is reached, the stock for any short sale must be borrowed. There is no reason that this requirement needs to be confined to regular trading hours, thus this proposal can police the after-hours markets while the other proposals cannot.

This circuit-breaker proposal could be scalable; the election level X could be adjusted up or down depending upon general market volatility on a quarterly basis. This could also allow the circuit breaker to be easily adjusted for public policy reasons at very little cost.

This circuit-breaker approach could also be used to trigger other behavior modifying events on the back-office level. For example, after triggering election level X+Y margin requirements on further short selling in a security flagged as distressed could be increased to further discourage activity.

The mandatory borrow helps to address the “magnet effect,” one of the concerns regarding trading curbs. The “magnet effect” occurs when a stock approaches the trading curbs “threshold”. Evidence shows that

short sellers (and possibly long sellers) pressure the stock down to the price where the curbs are triggered trying to execute their sales prior to the ban. The mandatory borrow requirement would introduce economic disincentives to borrow/short a stock once the curbs are triggered. The “magnet effect” could be avoided as the short sellers would want to avoid any increased costs associated with the mandatory borrow and long sellers should remain unaffected by the ban.

The Security Traders Association recommends this approach based upon its simplicity, cost/time to implement, relative ease of compliance and enforcement and retention of market quality. The STA believes that this circuit-breaker proposal solves the vast majority of the issues surrounding trade benchmarks. Our circuit-breaker proposal reduces the “magnet effect,” reduces the likelihood of potential manipulators piling on and pressing bets, and reduces any gaming prospects. It efficiently allocates the costs of regulation and is easily complied with, as well as easily enforced, all while maintaining the functionality of the market that has worked well over a very troubled time. We acknowledge that this proposal does nothing to police activities in the unregulated derivatives market, but also note that it provides less motivation for participants to relocate their trading strategies to those markets and the circuit breaker/mandatory borrow more closely resembles other regulation regimes around the world, allowing for greater international regulatory coordination. This solution efficiently attacks the problem of abusive short selling while allowing free and fair markets to operate.

Sincerely,



Peter J. Driscoll  
Chairman



John C. Giese  
President & CEO

cc: Hon. Luis A. Aguilar  
Hon. Kathleen L. Casey  
Hon. Troy A. Paredes  
Hon. Elisse B. Walter  
James Brigagliano, Deputy Director, Division of Trading and Markets