



**Regulatory Analysis:
The SEC on Short Selling – Spring 2009 Edition**

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The US Securities and Exchange Commission has unveiled a series of proposals for improving investor protection in US equity market short selling. We review each possible strategy and offer our suggestions for a best solution.

Continuing to walk the line between individual protection and investor liberty, the US Securities and Exchange Commission has produced a series of recommendations for what a new short selling regulatory policy might look like. The SEC has emerged with two broad types of recommendations, each recognizing the diverse interests of the investor community, and has asked for public comment. The SEC has characterized these recommendations by market-wide, permanent approaches and security-specific, temporary approaches.

In general, we find the SEC's proposals in this matter to be measured; most are neither a full throwback to the pre-Reagan era of investor protection nor do they cater to the needs of the brokerage community as the Bush administration appeared ready to do. That said, there are policies we prefer and others we do not.

Market-Wide Approaches

The SEC is proposing to institute regulations that affect the entire market at all times. These regulations would encompass all securities trading in all venues with no exceptions. Specifically, the SEC is considering either re-instituting the uptick rule by trading venue or imposing a modified uptick rule that looks at the national best bid and offer.

We are opposed to market-wide approaches to short selling regulation at this time. From a philosophical standpoint, we feel that uptick rules put undue restrictions on investors. Put another way, we think that uptick rules in general step too far over the line between individual protection and investor liberty in favor of individuals. If investors want to short a stock and that causes no harm or thought of market manipulation, they should not be subject to a tick-test before completing their transaction.

From a practical perspective, we see the market-wide approaches as being difficult to implement under existing US market linkages and forms of data communication (Reg NMS). The US equity environment is highly fragmented with over 50 trading venues. Imposing market-wide restrictions, whether market-by-market or using a national best bid and offer as the litmus test, would require each market operator to institute new monitoring for their transactions to be in compliance. While not impossible, we believe that this approach imposes extra costs at an unwelcome time for individual firms.

Security-Specific Approaches

The SEC has also proposed security-specific regulation that would curtail trading if certain conditions were met. This is the circuit breaker approach, which are already common in equity markets if certain movements away from an index are met during a trading day. In prior works we have noted that circuit breakers support our notion of the balance between investor liberty and individual protection. Investors have freedom of movement within clearly defined boundaries while individuals feel secure that the markets will not get “out of control” in times of extreme volatility.

The SEC has noted three different variations of a circuit breaker for individuals stocks in times of an excessive sell-off:

- 1) Ban short selling in a particular security for the remainder of the day if there is a severe decline in price in that security (a proposed circuit breaker halt rule).
- 2) Impose a short sale price test based on the national best bid in a particular security for the remainder of the day if there is a severe decline in price in that security (a proposed circuit breaker modified uptick rule).
- 3) Impose a short sale price test based on the last sale price in a particular security for the remainder of the day if there is a severe decline in price in that security (a proposed circuit breaker uptick rule).¹

We support option 2 as the most viable of these three alternatives. We view option 1 as too extreme and reminiscent of the objectionable market-wide approaches already presented. We view option 3 as difficult to implement for many trading venues and hence overly burdensome in terms of cost.

Option 2 is the most accessible for the greatest number of trading firms, imposes the least costs and leverages existing data infrastructure. We would go one step further and support the proposal of the US exchanges, whereby if a circuit breaker were tripped only certain types of orders would be accepted. This is a manageable solution that obtains the same goal of investor protection as Option 2; by monitoring the national best bid and offer, an individual market operator can simply elect to no longer receive certain types of order messages.

What the SEC Has Not Proposed

Unfortunately the SEC has shied away from discussing the solution we favor most: increased disclosure of short selling activity back to the trading firm. While we do not seek public disclosure, we feel that if the SEC or FINRA had the ability to effectively capture data on short selling and other transactions, and connect those data back to the broker-dealer and client in question, this would go furthest in eliminating potential market abuses. The SEC’s current action in mandating Form SH, which discloses short positions held for a week or more, does not capture intraday trades. The SEC has no mechanisms besides coercion or subpoenas to collect intraday trading data, and even then must manage the ensuing volumes of information. While individual market surveillance teams monitor some intraday trading activity, their abilities are hampered by the kinds of data they collect and the resources at their disposal.

We recognize that our proposal is unrealistic to implement quickly and bears some real costs itself, but this is the age of government spending initiatives. In the end, we see a strong central market surveillance team as the best solution to the ongoing problem of managing the line between investor protection and individual liberty.

¹ From <http://sec.gov/news/press/2009/2009-76.htm>