

WEEDEN & Co.
INCORPORATED

Short sales



DONALD E. WEEDEN
chairman
board of directors

November 15, 1974

Mr. Lee A. Pickard, Director
Division of Market Regulation
Securities and Exchange Commission
500 North Capitol Street, N.W.
Washington, D. C. 20549

Dear Lee:

The New York Stock Exchange, the regional exchanges and the Commission are at odds with one another over what kind of a new short selling rule would be appropriate once we have a consolidated tape.

The significance of the dispute lies not in the impact of the short selling rule itself, however it is ultimately worded, but in the further delay of the crucial development work needed to perfect the consolidated tape.

For the past thirty-five years, more precisely since January 1938, the securities industry has operated under the so-called "plus tick" short selling rule. The "plus tick" rule may not make all that much sense, but it has worked. Unfortunately, it has been applied uniformly to all brokers and dealers whether they were dealing on their own account as specialists, market makers or floor traders, or whether they were representing the public, handling agency orders as brokers.

In September of this year the Commission announced a new rule, an amendment of the old rule, which would extend the "plus tick" test to all transactions in listed stocks, not just those effected on registered exchanges. More significantly, and this is where the dispute arises, the test for determining the last sale -- the "plus tick" transaction -- is no longer the last sale on the New York Stock Exchange or the relevant regional exchange, but wherever the last sale occurs -- whether on the New York Stock Exchange, the regionals or the Third Market.

To this the New York Stock Exchange objects. It finds offensive the notion that sales on competing markets, as reported on the consolidated tape, will henceforth govern the conduct of its members. Behind the technical complexities of its lengthy submission of October 11, 1974, lies the basic concern that any substantial implementation of the consolidated tape threatens the New York Stock Exchange with loss of business -- loss to the regionals and the Third Market. The New York Stock Exchange may be right; but if it is, the problem goes far deeper than any mere change in the short selling rule.

Others, with less parochial concerns, have objected to the broad sweep of the new rule. For them the so-called Uniform Rule distorts existing ways of doing business for no apparent regulatory purpose.

We at Weeden & Co. find the entire confrontation a bit overstated. The threat by the New York Stock Exchange to withdraw from the consolidated tape unless the Uniform Rule is changed seems excessive to the problem at hand. After all, less than 2% of all transactions in listed stocks are short sales for public customers. That being the case, we are forced to the conclusion that there is not a great deal of "public interest" involved in the proposed change. The Exchange must know and the Commission should know that most short selling is done by those of us who make markets -- whether as specialists, block traders or Third Market makers. Accordingly, we think the proper focus of the Commission's regulatory concern should be registered brokers and dealers acting for their own account. That is the group that accounts for the overwhelming bulk of short selling. We are the insiders most likely to possess the power and proximity to engage in the bear raids the rule was originally designed to prevent.

Indeed, a reading of the Commission's original statement announcing the short selling rule in 1938 makes it abundantly clear that the real evil in short selling that brought about the "plus tick" rule was fraudulent and manipulative trading by a handful of New York Stock Exchange floor traders in three stocks during two short market breaks in the fall of 1937.

Of course, those with knowledge of the New York Floor back in the Thirties readily confirm that concentrated short selling was no mere happenstance, the accidental result of individual traders acting individually. There were in fact bear rings; bear rings that operated in full view of the Governors of the New York Floor. Quite clearly the short selling rule of the Thirties was the Commission's response, however blunt, to the conniving of those insiders.

By Seventies standards, meaning in the age of the computer, we no longer need so blunt an instrument. Concerted action by insiders or outsiders or a combination of both can be identified and prosecuted as market manipulation with severe, deterring penalties for all of those involved.

The problem is how to unlearn the nearly forty years of experience under the old, unrefined short selling rule? In the interim, many have come to think that all short selling is inherently evil, to be eliminated or at least discouraged by imposing complex rules.

But is that an accurate appraisal of what is required for stable markets? "Short-selling is no more dangerous or evil than ordinary selling or buying. If short-selling were easier and less costly, there would be more of it with a consequent increase in

the liquidity of the market and in its efficiency." ("Public Policy for American Capital Markets", Department of the Treasury, 1974, page 10.) As that quotation from the Lorie Report suggests, it may well be that more short selling these days might reduce the volatility of our present markets.

In its March 6, 1974 release, the Commission signalled its concern by proposing for comment variations on the short selling theme: (a) the prohibition of short sales below the lowest independent offer, or (b) below a specified predetermined price such as the previous day's closing price, or low or same day's opening, or (c) the limitation to a predetermined amount of the outstanding publicly-held stocks. (Exchange Act Rel. 10668, March 6, 1974.)

We understand that the public response has not been overwhelming. Apparently short selling is of interest primarily to market makers and they get fewer in number each day and certainly less vocal.

For those willing to think about short selling with an open mind, in the light of today's market conditions, we think the most direct answer is that short selling cannot be quantitatively controlled unless the Commission is willing to go much further and say long buying should also be controlled. Since no one seriously advocates limiting the amount that markets can move up

from sale to sale, it should also be clear that we ought no longer reach, Thirties style, for every pump priming device which seeks to keep prices from going down. In short, the real need of tomorrow's enlarged central market is not mechanical, Blue Eagle type "plus tick" or "minus tick" restraints on market swings. The challenge is to find new ways to bring more capital to bear on the increased volume of an institutionalized market. That is the simple answer.

The more complicated answer is that short selling should be qualitatively controlled; that is prohibited when it is fraudulent or manipulative, but not otherwise.

The reason that is a complicated answer is that a short selling rule aimed primarily at fraudulent practices and manipulative trading will require the Commission to put aside theoretical, a priori regulation and start examining actual transactions in order to develop a body of law on when short selling is good and when it is bad. In the age of the computer, the old bromides, the broad characterizations, about short selling, pro and con, are plainly inadequate. Plainly, all short selling is not destabilizing. Neither is all short selling stabilizing. We have to develop more refined rules which distinguish between bear raids and balanced market making.

Actually, fashioning qualitative controls may not be all that difficult. We think the lines to be drawn are no more simple, complex or different than those applied to all businessmen in general commerce -- fraudulent or collusive behavior to affect market price is prohibited, bona fide individual action is permitted, encouraged.

The answer, then, has two parts. For the time being -- that is until the Commission has gathered more data -- dealers should continue to be subject to the "plus tick" test, while the public -- translate "brokers handling agency orders" -- should be free to sell short without mechanical restrictions. The first part of our answer to the Uniform Rule question, then, is to focus on brokers and dealers acting for their own account and to refine the rule by eliminating any mechanical tick test restraint on public, agency transactions, since they constitute less than 2% of all transactions in listed stocks.

The second part of the answer is to breathe new life into the existing rules and regulations against fraudulent practices and manipulative trading. Those with regulatory responsibility must learn to use the computer and its ability to recall in sequence each transaction to ferret out those cases of fraud or collusive behavior where two or more persons -- public or professional, individual, institutional or insider, off board or on an exchange floor -- act in concert to attempt a bear raid. In short, the job

is to define by case law what kinds of short selling are fraudulent or manipulative. In so doing, the Commission will fill an important gap in existing enforcement.

The last thing this industry needs right now is additional trading rules, opaquely written and only dimly understood even by professionals. We see the computer as capable of changing the Commission's basic regulatory methodology by emphasizing facts over theory. We no longer need to fashion whole strings of complex restrictions in an effort to anticipate every new, imagined evil. Today we have the capacity at nominal cost and with precision to recall the data from which the regulators can tell whether any person or group has been trying to rig a market. By so doing, those who are found guilty can be subjected to more than a mere slap on the wrist for violating a complex, technical short selling rule. They can and should be punished for the Old Testament wrongs of fraud or market manipulation.

To conclude, the solution to the present impasse over a new short selling rule for an enlarged central market is to focus the spotlight of regulation on those with the power and proximity to destabilize markets, to wit, brokers and dealers trading for their own account. They should be obliged to observe the "plus tick" test, regardless of the market in which they elect to trade.

At the same time, by refining the Uniform Rule to exclude the small number of public agency orders and using the computer to go after fraudulent and manipulative trading, we have the prospect of holding the regulated to a higher level of compliance and the regulators to a higher level of enforcement.

Sincerely,

A handwritten signature in black ink, appearing to be the initials 'Dm'.

DEW/mm